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TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1945

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 22, 1945.

CERTIORARI GRANTED FEBRUARY 11, 1946.

SUPREME COURT OF THE UNITED STATES

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JUDD & DETWEILER (INC.), PRINTERS, WASHINGTON, D. C., FEBRUARY 25, 1946.

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[fol. a] [Caption omitted]

[fol. 1]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 110566

BURTON-SUTTON OIL COMPANY, INCORPORATED, Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Taxpayer: Wright Matthews, W. W. Thompson, Norman F. Anderson, Elias R. Kaufman.

For Comm'r: Frank B. Schlosser, L. R. Van Burgh.

DOCKET ENTRIES

1942-

Apr. 14. Petition received and filed. Taxpayer notified. Fee paid.

Apr. 15. Copy of petition served on General Counsel.

May 29. Answer filed by General Counsel.

May 29. Request for hearing in New Orleans, Louisiana, filed by General Counsel.

June 5. Notice issued placing proceeding on New Orleans, Louisiana, calendar. Answer and request served.

Dec. 10. Hearing set Jan. 18, 1943, in New Orleans, Louisiana.

1943

Jan. 12. Motion to remove case from New Orleans, Louisiana, calendar and place it on the next Houston, Texas, calendar filed by taxpayer. 1/12/43 Granted.

[fol. 2] Mar. 5. Hearing set April 5, 1943—Houston, Texas.

Apr. 5. Hearing had before Judge Leech on motion of petitioner for a continuance. Motion Granted. Continued to next session at Houston, Texas. Motion filed.

Sept. 16. Hearing set Oct. 25, 1943—Galveston, Texas.

Sept. 27. Stipulation to take deposition of W. W. Thompson filed.

1943

Oct. 8. Deposition of W. W. Thompson filed. General Counsel and taxpayer served by notary.

Oct. 25. Hearing had before Judge Black on merits. Submitted. Stipulation of facts filed. Briefs due 1-2-44. Replies Jan. 17, 1944.

Nov. 30. Transcript of hearing 10/25/43 filed.

Dec. 10. Motion for extension to Feb. 15, 1944, to file brief filed by taxpayer. 12/10/43 granted as to both parties.

1944

Feb. 10. Brief filed by taxpayer.

Feb. 15. Brief filed by General Counsel. Served 2/16 44.

Feb. 15. Copy of brief served on General Counsel.

Aug. 4. Findings of fact and opinion rendered. Black, J. Decision will be entered under Rule 50. Copies served.

Sept. 4. Computation as to deficiency filed by General Counsel.

Sept. 6. Hearing set 9/27/44 on settlement.

Sept. 27. Hearing before Judge Black; settlement under Rule 50. Settlement uncontested.

Sept. 30. Decision entered—Black, J., Div. 15.

Oct. 30. Entry of appearance of W. W. Thompson as counsel.

Oct. 31. Motion to withdraw Wright Matthews as counsel for taxpayer filed. 10/31/44 Granted.

[fol. 3] Nov. 21. Notice of appearance of Norman F. Anderson, C. P. A., Elias R. Kaufman and W. W. Thompson as counsel filed.

Nov. 29. Bond in the amount of $380,000.00 approved and ordered filed.

Dec. 11. Petition for review by U. S. Circuit Court of Appeals, Fifth Circuit, with assignments of error, filed by taxpayer.

Dec. 11. Proof of service filed by taxpayer.

Dec. 11. Praecipe for record filed by taxpayer.

Dec. 11. Proof of service filed.

Dec. 15. Petition for review by U. S. Circuit Court of Appeals, Fifth Circuit, with assignments of error filed by General Counsel.

Dec. 28. Proof of service filed (2).

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 110566

BURTON-SUTTON OIL COMPANY, INCORPORATED, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

PETITION—Filed April 14, 1942

The above named petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his notice of deficiency dated January 16, 1942, and as a basis of its proceeding alleges as follows:

1. The petitioner is a corporation organized and doing business under the laws of the State of Louisiana with [fol. 4] its principal office in Lake Charles, Louisiana. The returns for the periods here involved were filed with the Collector of Internal Revenue for the District of Louisiana, said Collector's office being located at New Orleans, Louisiana.

2. The notice of deficiency, a copy of which is attached hereto marked Exhibit A, was mailed to the petitioner on January 16, 1942.

3. The taxes in controversy are income and excess profits taxes for the fiscal years ended February 29, 1936, February 28, 1937 and February 28, 1938, and are in the following amounts:

	Income Tax	Excess Profits Tax
1936	$10,799.01	$667.42
1937	66,341.26	27,899.87
1938	82,655.94	32,157.86
	$159,796.21	$60,725.15

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) For the taxable year ended February 29, 1936, the Commissioner erred in eliminating $8,591.09 of depreciation which the petitioner claimed on its return for said year.

(b) For the taxable year ended February 29, 1936, the Commissioner erred in adding to income an amount of $17,406.19 which the petitioner had paid to the Gulf Refining Company under a contract hereinafter explained and which amount the petitioner did not report as its income for said year.

[fol. 5] (c) For the taxable year ended February 28, 1937, the Commissioner erred in disallowing $1,073.82 which the petitioner claimed in its return as a deduction on account of timber construction.

(d) For the taxable year ended February 28, 1937, the Commissioner erred in adding to the income of petitioner the amount of $232,498.94, which amount had been paid to the Gulf Refining Company by the petitioner under a contract hereinafter explained, and which amount the petitioner did not report as its income for said year.

(e) For the taxable year ended February 28, 1937, the Commissioner erred in not deducting from the petitioner's income the amount of $814.11 additional franchise tax for said year which has been asserted and paid by the petitioner to the State of Louisiana and the amount of $15,025.42 income tax which has been asserted by the State of Louisiana against this petitioner for the taxable year ended February 28, 1937.

(f) For the taxable year ended February 28, 1938, the Commissioner erred in disallowing $27,564.61 legal expenses which the petitioner claimed on its return for said year.

(g) For the taxable year ended February 28, 1938, the Commissioner erred in disallowing $815.15 of the depreciation which the petitioner claimed in its return for said year, instead of allowing $4,054.66 in addition to the amount of depreciation which petitioner claimed on its return for said year.

(h) For the taxable year ended February 28, 1938, the Commissioner erred in disallowing $948.33 as a deduction for timber construction, which the petitioner claimed in its return for said year.

[fol. 6] (i) For the taxable year ended February 28, 1938, the Commissioner erred in adding to the petitioner's in-

come the amount of $286,128.23, which said amount was paid by the petitioner to the Gulf Refining Company during said year as the result of the contract hereinafter explained, and which amount the petitioner did not include as its income for said year.

(j) For the taxable year ended February 28, 1938, the Commissioner erred in not deducting $1,237.83 additional franchise tax which was asserted by the State of Louisiana and which has been paid by the petitioner to the State of Louisiana for the taxable year ended February 28, 1938. For the taxable year ended February 28, 1938, the Commissioner also erred in not deducting from the petitioner's income the amount of $15,750.00 additional income tax which the State of Louisiana has asserted against the petitioner for the taxable year ended February 28, 1938.

5. The facts upon which the petitioner relies as a basis of this proceeding are as follows:

(a) Petitioner deducted on its income tax return for the year ended February 29, 1936, depreciation upon equipment used in connection with its oil and gas properties in the total amount of $33,167.45. The Commissioner has erroneously allowed depreciation on said equipment for said year in the total amount of $24,576.36 only, computed as shown in Exhibit B attached hereto. All of the equipment upon which said depreciation was computed was subject to heavy usage in the oil and gas business; and the estimated lives of the different classes of said equipment used by petitioner in computing depreciation were fair and reasonable estimates and result in a fair and reasonable amount of depreciation. Minor mathematical errors in computation were made by petitioner in its return. Attached hereto, marked Exhibit D, and made a part hereof, is a [fol. 7] computation of depreciation, based upon the fair and reasonable estimated lives used by petitioner in its return, which, after adjusting the minor errors in the return, reflects allowable depreciation of $33,070.42. Said amount of $33,070.42 is a fair and reasonable allowance to petitioner for depreciation for the fiscal year ended February 29, 1936.

(b) During the taxable year ended February 29, 1936, the petitioner paid to the Gulf Refining Company $17,406.19. This amount was paid to the Gulf Refining Company by

virtue of a contract which had been entered into between that company and one J. G. Sutton on February 18, 1933. The said J. G. Sutton transferred this contract to the petitioner on or about February 27, 1933. Under the terms of that contract the said J. G. Sutton bound himself to develop and operate the properties, meet the underlying and overriding royalty obligations, reimburse himself for all costs and expenses of operating the property, and account to and pay to the grantor fifty percent of the remaining portion of the oil and gas produced and sold from the said land. The restrictions placed upon the assignment and the delivery of possession of this lease to Sutton are such as to constitute a reservation by the said Gulf Refining Company of an interest in the lease. The Commissioner of Internal Revenue contends that the amounts paid the Gulf Refining Company represent a part of the cost of the lease and are therefore not to be deducted or excluded from taxable income, except as they are recovered through depletion. The Gulf Refining Company retained a substantial interest in this lease, and the amounts paid it were paid by virtue of its joint ownership of the properties and not in consideration of the transfer of said properties. Said amounts, therefore, constituted income of the Gulf Refining Company and never became the income of the petitioner.

[fol. 8] (c) During the fiscal year ended February 28, 1937, petitioner expended and incurred the amount of $1,073.82 which said amount was designated as "Timber Construction" and which petitioner deducted on its return for said year under said designation. This amount was expended and incurred for intangible costs in connection with timber work on its Well No. 20 and represents the costs of constructing derrick floor, pipe racks, pipe skids, derrick substructure, etc., in connetion with the drilling of said well. Said costs did not result in the acquisition of any asset having a salvage value; and said costs were properly deductible as intangible drilling costs in the computation of petitioner's taxable income for the year ended February 28, 1937. The Commissioner has erroneously capitalized said costs as representing a tangible asset subject to an allowance for depreciation in petitioner's hands.

(d) During the taxable year ended February 28, 1937, the petitioner paid to the Gulf Refining Company the sum of $232,498.94 under the contract of February 18, 1933,

described under subparagraph 5(b) hereinabove. The facts with reference to this payment under said contract of February 18, 1933, are the same as set forth under subparagraph 5(b) hereinabove, with the exception of the amount of said payment; and full reference, for all purposes as fully as though said facts were again here stated, is here made to said sub-paragraph 5(b) hereinabove.

(e) The State of Louisiana, since the filing of petitioner's income tax return for the taxable year ended February 28, 1937, has asserted and petitioner has paid additional franchise taxes for said year in the amount of $814.11; and the State of Louisiana has further asserted against petitioner additional income taxes for said year in the amount of $15,025.42. Petitioner filed its return for said year on the accrual basis; and said State of Louisiana taxes in the amounts of $814.11 and $15,025.42, re- [fol. 9] spectfully, are properly allowable deductions in the computation of petitioner's income and excess profits tax liability for the taxable year ended February 28, 1937. The Commissioner, however, has failed and refused to allow said amounts as deductions in his computation of petitioner's tax liability for said year.

(f) The Commissioner in his ninety day letter contends that the amount of $27,564.61 was incurred in connection with litigation covering a large tract of land and that the expenditure of said amount was in defending and protecting title to the property, and as such said expenditures are specifically excluded from allowable deductions under the regulations of said Commissioner of Internal Revenue. The facts are that this amount was expended in resisting condemnation proceedings instituted by the United States of America. The petitioner had possession of the property for a period of years, had developed the property, obtained production of oil and was deriving a large income therefrom. The nature of the litigation, its process through the Courts, and the final determination of the litigation, in so far as this petitioner is concerned, and in so far as the final order of the Court was concerned, constitute the attorney's fees as legitimate business expense paid to protect the petitioner's right to its undisturbed enjoyment of its property and the yields from said property; and as such the expenditure was clearly an ordinary and necessary business expense deductible from gross income.

(g) Petitioner is entitled to a deduction for depreciation on equipment used in connection with its oil and gas business for the taxable year ended February 28, 1938, in the amount of $63,882.91, as shown by computation attached hereto, marked Exhibit E, and made a part hereof. All of the equipment upon which said depreciation is allowable was subject to heavy usage in the oil and gas business; and the estimated lives of the different classes [fol. 10] of said equipment shown in said Exhibit E are fair and reasonable estimates and result in a fair and reasonable allowance for depreciation in the amount of $63,882.91, all as shown in said Exhibit E. Petitioner deducted in its return for said year ended February 28, 1938, depreciation in the amount of only $59,828.25, and therefore is entitled to an additional deduction for said purpose of $4,054.66 in excess of that claimed in the return. The Commissioner has erroneously allowed only $59,013.10 for depreciation, computed as shown by Exhibit C attached hereto.

(h) During the fiscal year ended February 28, 1938, petitioner expended and incurred the amount of $948.33 designated and deducted in petitioner's return for said years as "Timber Construction". This amount was expended and incurred for intangible costs in connection with timber work on its Well No. 18, which was a dry hole; and said amount represents the costs of constructing derrick floor, pipe racks, pipe skids, derrick substructure, etc., in connection with the drilling of said dry hole. Said costs did not result in the acquisition of any asset having a salvage value and said costs were properly deductible as intangible drilling costs in the computation of petitioner's taxable income for the year ended February 28, 1938. The Commissioner has erroneously capitalized said costs as representing a tangible asset subject to an allowance for depreciation in petitioner's hands.

(i) During the taxable year ended February 28, 1938, the petitioner paid to the Gulf Refining Company the sum of $286,128.23 under the contract of February 18, 1933, described under sub-paragraph 5(b) hereinabove. The facts with reference to this payment under said contract of February 18, 1933, are the same as set forth under said sub-paragraph 5(b) hereinabove except as to the amount of said payment; and full reference, for all purposes as

fully as though said facts were again here stated, is made to said sub-paragraph 5(b) hereinabove.

[fol. 11] (j) The State of Louisiana, since the filing of petitioner's income tax return for the taxable year ended February 28, 1938, has asserted and petitioner has paid additional franchise taxes for said year in the amount of $1,237.83. The State of Louisiana has further asserted against petitioner additional income taxes for said year in the amount of $15,750.00. Petitioner filed its income tax return for said year on the accrual basis; and said State of Louisiana taxes in the amounts of $1,237.83 and $15,750.00, respectively, are properly allowable deductions in the computation of petitioner's income and excess profits tax liability for the taxable year ended February 28, 1938. The Commissioner has failed and refused to allow said amounts as deductions in his computation of petitioner's tax liability for said year.

Wherefore, the petitioner prays that this Board may hear the proceedings and in its final order render a judgment that the petitioner owes no part of the deficiencies asserted by the Commissioner of Internal Revenue in letter dated January 16, 1942.

Wright Matthews (Wright Matthews), Attorney for Petitioner.

3017 Gulf Building, Houston, Texas.

Duly sworn to by Wm. T. Burton; jurat omitted in printing.

[fol. 12] EXHIBIT "A" TO PETITION

Form 1232 SN-IT-3

Treasury Department

Internal Revenue Service, New Orleans, Louisiana

Office of Internal Revenue Agent in Charge, New Orleans Division

Jan. 16, 1942.

Burton-Sutton Oil Company, Incorporated, Lake Charles, Louisiana.

SIRS:

You are advised that the determination of your income tax liability for the taxable year(s) ended February 29, 1936, February 28, 1937 and 1938, discloses a deficiency of $159,796.21 and that the determination of your excess-profits tax liability for the year(s) mentioned discloses a deficiency of $60,725.15, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition [fol. 13] with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, New Orleans, Louisiana, for the attention of —. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or of the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner.
(Signed) By William E. Logan, Internal Revenue Agent in Charge.

Enclosures: Statement. Form of waiver.

JML/lr.

Statement

Burton-Sutton Oil Company, Incorporated, Lake Charles, Louisiana

Tax Liability for the Taxable Years Ended February 29, 1936, and February 28, 1937, and 1938

[fol. 14]

Income Tax

Year	Liability	Assessed	Deficiency
1936	$20,698.31	$9,899.30	$10,799.01
1937	89,361.54	23,020.28	66,341.26
1938	92,397.94	9,742.00	82,655.94
Totals	$202,457.79	$42,661.58	$159,796.21

Excess-Profits Tax

1936	$1,073.77	$406.35	$667.42
1937	36,264.36	8,364.49	27,899.87
1938	32,795.22	637.36	32,157.86
Totals	$70,133.35	$9,408.20	$60,725.15

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the reports of examination dated February 12, 1938, November 29, 1938, April 11, 1939, and March 18, 1940; to your protests dated March 4, 1939, May 9, 1939, April 25, 1940, and September 6, 1941; to the statements made at the conferences held on April 27, 1939, September 28, 1939, November 24, 1939, May 31, 1940, and June 25, 1941; and to your claim for refund filed on September 28, 1936.

It is held that payment made to Gulf Refining Company of Louisiana in each of the years 1936, 1937 and 1938 in accordance with the contract whereby you acquired the lease to a section of State school land in Cameron Parish, Louisiana, represent a part of the cost of that lease, and are therefore not to be deducted or excluded from taxable income, except as they are recovered through depletion. Since in each of the years under consideration percentage [fol. 15] depletion is greater than depletion based on cost of the lease, adjusted for depletion previously allowed, percentage depletion has been allowed in each year.

If a petition to the United States Board of Tax Appeals is filed against the deficiency proposed herein, the issue set forth in your claim for refund should be made a part of the petition to be considered by the Board in any redetermination of your tax liability. If a petition is not filed the claim for refund will be disallowed and official notice will be issued by registered mail in accordance with section 3772 of the Internal Revenue Code.

A copy of this letter and statement has been mailed to your representatives, Mr. W. W. Thompson, Weber Building, Lake Charles, Louisiana, Mr. Ulan Hill, Esperson Building, Houston, Texas, Mr. Wright Matthews, Esperson Building, Houston, Texas, Mr. Beverly Tobin, Esperson Building, Houston, Texas, in accordance with the power of attorney executed by you.

Taxable Year Ended February 29, 1936

Adjustments to Net Income

Net income as disclosed by return		$122,322.34
Unallowable deductions and additional income:		
(a) Excessive depreciation	$8,591.09	
(b) Excessive depletion	1,857.54	
(c) Loss on well equipment disallowed	356.03	
(d) Payments to Gulf Refining Company	17,406.19	28,210.85
Net income adjusted		$150,533.19

[fol. 16] Explanation of Adjustments

(a) It is held that you are entitled to deduction for depreciation in the amout of $24,576.36, as set out in statement of examination furnished to you under date of April 11, 1939, instead of the amount of $33,167.45 claimed on your return.

(b) It is held that you are entitled to deduction for depletion in the amount of $150,533.20, as set out in Exhibit A attached, instead of the amount of $152,390.74 claimed on your return.

(c) The deduction claimed on your return for loss of equipment resulting from blowout of well number 3 has been adjusted as follows:

Cost of equipment	$7,120.57
Less: Depreciation allowed or allowable	1,068.09
Loss sustained and allowable	$6,052.48
Loss deducted per return	6,408.51
Loss disallowed	$356.03

(b) This item represents payments made to Gulf Refining Company of Louisiana within the taxable year ended February 29, 1936, in accordance with the contract whereby you acquired the lease to a section of State school land in Cameron Parish, Louisiana.

Adjustment to Declared Value of Capital Stock

Value of capital stock as declared in your capital stock tax return for the year ended June 30, 1935	$1,029,994.17
[fol. 17] Increase in net income for the taxable year ended February 28, 1935	2,468.67
Value as adjusted	$1,032,462.84

Explanation of Adjustment

Net income for the taxable year ended February 28, 1935, as adjusted	$32,462.84
Net income as disclosed by return	29,994.17
Increase as above	$2,468.67

Computation of Tax

Excess-Profits Tax:

Taxable net income		$150,533.19
Less: 12½ percent of $1,032,462.84 adjusted value of capital stock as declared in your capital stock tax return for the year ended June 30, 1935		$129,057.86
Net income subject to excess-profits tax		$21,475.33
Excess-profits tax: 5 percent of $21,475.33		$1,073.77
Total excess-profits tax		$1,073.77
Excess-profits tax assessed:		
Original, account No. 400030	None	
Additional, January 1940 list, account No. 521207	$406.35	
Total assessed		$406.35
Deficiency of excess-profits tax		$667.42

[fol. 18] *Income Tax:*

Taxable net income		$150,533.19
Net income subject to income tax		$150,533.19
Income tax: 13¾ percent of $150,533.19		$20,698.31
Total income tax		$20,698.31
Income tax assessed:		
Original, account No. 400030	$16,819.32	
Additional, January 1940 list, account No. 521207	1,485.64	
Total assessed	$18,304.96	
Less: Previous allowance	8,405.66	
Net assessment		9,899.30
Deficiency of income tax		$10,799.01

Taxable Year Ended February 28, 1937

Adjustments to Net Income

Net income as disclosed by return		$138,474.46
Unallowable deduction and additional income:		
(a) Timber construction disallowed	$ 1,073.82	
(b) Payments to Gulf Refining Company	232,498.94	233,572.76
Total		$372,047.22
[fol. 19] Additional deductions:		
(c) Depletion	$53,591.85	
(d) Depreciation	1,551.81	
(e) Compensation claims	2,200.55	$57,344.21
Net income adjusted		$314,703.01

Explanation of Adjustments

(a) It is held that the amount of $1,073.82 expended for timber used in the construction of well number 18 represents a part of the cost of the well, and therefore not to be deducted or excluded from taxable income, except as recovered through depreciation. Refer to Exhibit A of report of examination dated November 29, 1938, a copy of which was furnished to you under date of January 7, 1939, for the computation of the amount of depreciation allowable for the taxable year.

(b) This item represents the amount of payments made to Gulf Refining Company of Louisiana within the taxable year ended February 28, 1937, in accordance with the contract whereby you acquired the lease to a section of State school land in Cameron Parish, Louisiana.

(c) It is held that you are entitled to deduction for depletion in the amount of $249,599.64, as set out in Exhibit A attached, instead of the amount of $196,007.79 claimed on your return.

(d) It is held that you are entitled to deduction for depreciation in the amount of $53,477.14, as set out in Ex-

hibit A of report of examination dated November 29, 1938, a copy of which was furnished to you under date of January 7, 1939, instead of the amount of $51,925.33 claimed on your return.

[fol. 20] (e) Deduction has been allowed for workmen's compensation claims paid in the taxable year in the amount of $2,200.55.

Computation of Tax

Excess-Profits Tax:

Taxable net income		$314,703.01
Less: 10 percent of $100,000.00 value of capital stock as declared in your capital stock tax return for the year ended June 30, 1936		10,000.00
Net income subject to excess-profits tax		$304,703.01
5 percent of declared value of capital stock		5,000.00
Balance		$299,703.01
Excess-profits tax:		
6 percent of $5,000.00		$300.00
12 percent of $299,703.01		35,964.36
Total excess-profits tax		$36,264.36
Excess-profits tax assessed:		
Original, account No. 853032	None	
Additional, May 26, 1939, #4 List, page 0, line 0	$8,364.49	
Total assessed		8,364.49
Deficiency of excess-profits tax		$27,899.87

Income Tax:

Normal Tax:	
Net income for excess-profits computation	$314,703.01
Less: excess-profits tax	36,264.36
Net income for normal tax computation	$278,438.65

[fol. 21]

8 percent of $2,000.00 (Over 0 to $2,000.00)		$160.00
11 percent of $13,000.00 (Over $2,000 to $15,000.00)		1,430.00
13 percent of $25,000.00 (Over $15,000 to $40,000.00)		3,250.00
15 percent of $238,438.65 (Over $40,000.00)		35,765.80
Total normal tax		$40,605.80
Surtax on Undistributed Profits:		
Net income for excess-profits computation		$314,703.01
Less:		
Excess-profits tax	$36,264.36	
Normal tax	40,605.80	76,870.16
Adjusted net income		$237,832.85
Undistributed net income		$237,832.85
7 percent of $23,783.29		$1,664.83
12 percent of $23,783.29		2,853.99
17 percent of $47,566.57		8,086.32
22 percent of $47,566.57		10,464.65
27 percent of $95,133.13		25,685.95
Total surtax		$48,755.74
Total normal tax		40,605.80
Total income tax (normal tax and surtax)		$89,361.54
Income tax assessed:		
Original account No. 853032	None	
Additional, May 26, 1939, #4 list, page 0, line 0	$23,020.28	
Total assessed		23,020.28
Deficiency of income tax		$66,341.26

[fol. 22] Taxable Year Ended February 28, 1938

Adjustments to Net Income

Net income as disclosed by return		$90,974.94
Unallowable deductions and additional income:		
(a) Legal expenses (disallowed)	$27,564.61	
(b) Excessive depreciation	815.15	
(c) Timber construction disallowed	948.33	
(a) Payments to Gulf Refining Company	286,128.23	315,456.32
Total		$406,431.26
Additional deduction:		
(e) Depletion		85,832.99
Net income adjusted		$320,598.27

Explanation of Adjustments

(a) The legal expenses incurred by you in connection with litigation covering a large tract of land within which is included the land on which you were conducting oil operations, are held to have been expended in defending and perfecting your title to the property, and as such, are specifically excluded from allowable deductions by article 24-2 of Regulations 94.

(b) It is held that you are entitled to deduction for depreciation in the amount of $59,013.10, as set out in Exhibit A of report of examination dated November 29, 1938, a copy of which was furnished to you under date of January 7, 1939, instead of the amount of $59,828.25 claimed on your return.

[fol. 23] (c) It is held that the amount of $948.33 expended for timber used for construction purposes represents a capital expenditure. Accordingly, the deduction claimed on your return has been disallowed and depreciation has been allowed on the amount capitalized as set out in Exhibit A of report of examination dated November 29, 1938.

(d) This item represents the amount of payments made to Gulf Refining Company of Louisiana within the taxable year ended February 28, 1938, in accordance with the contract whereby you acquired the lease to a section of State school land in Cameron Parish, Louisiana.

(e) It is held that you are entitled to deduction for depletion in the amount of $240,373.87, as set out in Exhibit A attached, instead of the amount of $154,540.88 claimed on your return.

Adjustment to Declared Value of Capital Stock

Value of capital stock as declared in your capital stock tax return for the year ended June 30, 1937	$238,474.46
Increase in net income for normal tax computation for the taxable year ended February 28, 1937	139,964.19
Value as adjusted	$378,438.65

Explanation of Adjustment

Net income for normal tax computation as adjusted	$278,438.65
Net income per return	138,474.46
Increase as above	$139,964.19

[fol. 24] Computation of Tax

Excess-Profits Tax:

Taxable net income	$320,598.27
Less: 10 percent of $378,438.65 adjusted value of capital stock as declared in your capital stock tax return for the year ended June 30, 1937	37,843.87
Net income subject to excess-profits tax	$282,754.40
5 percent of adjusted declared value of capital stock	18,921.93
Balance	$263,832.47

Excess-profits tax:		
6 percent of $18,921.93		$1,135.32
12 percent of $263,832.47		31,659.90
Total excess-profits tax		$32,795.22
Excess-profits tax assessed:		
Original, account No. 852959	None	
Additional, May 26, 1939, #4 list, page 0, line 2	$637.36	637.36
Deficiency of excess-profits tax		$32,157.86
Income Tax:		
Normal Tax:		
Net income for excess-profits computation		$320,598.27
Less: Excess-profits tax		32,795.22
Net income for normal tax computation		$287,803.05
8 percent of $2,000.00 (Over 0 to $2,000.00)		$160.00
11 percent of $13,000.00 (Over $2,000 to $15,000.00)		1,430.00
[fol. 25]		
13 percent of $25,000.00 (Over $15,000 to $40,000.00)		3,250.00
15 percent of $247,803.05 (Over $40,000.00)		37,170.46
Total normal tax		$42,010.46
Surtax on Undistributed Profits:		
Net income for excess-profits computation		$320,598.27
Less:		
Excess-profits tax	$32,795.22	
Normal tax	42,010.46	74,805.68
Adjusted net income		$245,792.59
Undistributed net income		$245,792.59
7 percent of $24,579.26		$1,720.55
12 percent of $24,579.26		2,949.51
17 percent of $49,158.52		8,356.95

22 percent of $49,158.52		10,814.87
27 percent of $98,317.03		26,545.60
Total surtax		$50,387.48
Total normal tax		42,010.46
Total income tax (normal tax and surtax)		$92,397.94
Income tax assessed:		
Original, account No. 852959	None	
Additional, May 26, 1939, #4 list, page 0, line 8	$9,742.00	9,742.00
Deficiency of income tax		$82,655.94

JPML/1r.

[fol. 26] Burton-Sutton Oil Company, Incorporated

Computation of Depletion

	Fiscal Year		
	1936	1937	1938
Gross income, less royalties	$554,755.81	$907,635.05	$874,086.80
Net income before depletion	$301,066.39	$564,302.65	$560,972.14
27½ percent of gross income	$152,557.85	$249,599.64	$240,373.87
50 percent of net income	$150,533.20	$282,151.33	$280,486.07
Depletion allowable	$150,533.20	$249,599.64	$240,373.87
Depletion deducted per return	152,390.74	196,007.79	154,540.88
Excessive depletion	$1,857.54		
Additional depletion		$53,591.85	$85,832.99

[fol. 27] EXHIBIT "B" TO PETITION

Revenue Agent's Computation of Depreciation for Fiscal Year Ended February 29, 1936
(From Revenue Agent's Report Dated April 11, 1939.)

Explanation of Adjustments:

(a) Depreciation deducted per return	$33,167.45
Depreciation allowable	24,576.36
Excessive	$8,591.09

Depreciation allowable has been computed in accordance with Article 23(l) 1 Regulations 86 as follows:

Item	Lease & Well Equipment	Drilling Equipment	Truck	Totals
Investment, Beginning	$ 46,226.25	$ 22,624.03	$606.25	$ 69,456.53
Additions	127,787.35	92,440.34		220,227.69
	$174,013.60	$115,064.37		$289,684.22
Retirements	7,120.57			7,120.57
Investment, End	$166,893.03	$115,064.37	$606.25	$282,563.65
Average for Year	$106,559.64	$ 68,844.20	$606.25	
	10%	20%	25%	
Reserve, Beginning	$ 6,359.04	$ 3,770.67	$303.12	$ 10,432.83
Charges	7,120.57			7,120.57
	($ 761.53)			$ 8,312.26
	10,655.96	13,768.84	151.56	24,576.36
	$ 9,894.43	$ 17,539.51	$454.68	$ 27,888.62

[fol. 28] EXHIBIT "C" TO PETITION

Revenue Agent's Computation of Depreciation for Fiscal Year Ended February 28, 1938
(From Revenue Agent's Report Dated January 7, 1939.)

(Schedule Continued on Following Page.)

Line		Date Acquired	Cost Per Books	Adjustments	Basis
1	Casing, Tubing, Screen, etc.	F. Y. 1934	22,135.62		22,135.62
2		F. Y. 1935	2,574.05		2,574.05
3		F. Y. 1936	105,608.09		105,708.09
4		F. Y. 1937	16,539.62		16,539.62
5		F. Y. 1938	3,530.98		3,530.98
			150,388.36		150,388.36
7	Timber Construction	F. Y. 1935	8,011.25		8,011.25
8		F. Y. 1936	7,917.28		7,917.28
9		F. Y. 1937		1,073.82	1,073.82
10				948.33	948.33
11			15,928.53		17,950.68
12	Field Equipment	F. Y. 1935	6,384.76		6,384.76
13	Pumps	F. Y. 1937	39,929.01		39,929.01
[fol. 29]					
14	Tanks	F. Y. 1937	10,786.09		10,786.09
14		F. Y. 1937	51,594.27		51,594.27
16	Various	F. Y. 1938	37,056.62		37,056.62
17			145,750.75		145,750.75
18	Drilling Equipment	F. Y. 1935	22,624.03		22,624.03

19	Drilling Equipment	F. Y. 1936	92,440.32		92,440.32
20			115,064.35		115,064.35
21	Truck	F. Y. 1935	606.25		606.25
22	Steel Derricks	F. Y. 1936	14,261.98		14,261.98
23		F. Y. 1938	1,722.69		1,722.69
24			15,984.67		15,984.67
25			443,722.91		445,745.06

[fol. 30]

Revenue Agent's Computation of Depreciation for Fiscal Year Ended February 28, 1938.
(From Revenue Agent's Report Dated January 7, 1939.)
(Continuation of Schedule from Preceding Page.)

Line From Preceding Page	Prior Depreciation R. A. R.-36	Unrecovered Cost	Life Used	Remaining Life 3-1-36	% Allowed Year Acquired	Depreciation 1938
1	5,533.90	16,601.72	10	7½		2,213.56
2	514.54	2,059.51	10	8		257.41
3	5,280.40	100,327.69	10	9½		10,560.81
4	None	16,539.62	10	10	½	1,653.96
5	None	3,530.98	10		½	176.55
6						
7	1,845.45	6,165.80	10	8		770.72
8	395.86	7,521.42	10	9½		791.73
9	None	1,073.82	10	10	All	107.38
10	None	948.33	10		All	94.83
11						
12	1,272.96	5,111.80	10	8		638.48
13	None	39,929.01	10	10	All	3,992.90
14	None	10,786.09	10	10	All	1,078.61
15	None	51,594.27	10	10	½	5,159.43
16	None	37,056.62	10		½	1,852.83
17						
18	12,426.68	10,197.35	4	2		5,098.67
19	11,555.04	80,885.28	4	3½		23,110.08
20						
21	454.69	151.56	3	1		None
22	648.27	13,613.71	11	10½		1,298.54
23	None	1,722.69	11		All	156.61
24						
25						59,013.10

[fol. 31]

EXHIBIT "D" TO PETITION

Depreciation

Fiscal Year Ended February 29, 1936

Date Acquired	Property	Cost	Estimated Life	Depreciation Prior Years	Depreciation Year Ended 2/29/36 Time	Depreciation Year Ended 2/29/36 Amount
1933-1934	Casing, Tubing & Screen	$ 24,709.67	9 Years	$1,392.41	12 Mos.	$2,745.52
1936	Casing, Tubing & Screen	105,608.09	10 Years	—0—	6 Mos.	5,280.41
1933-1934	Timber Construction	8,011.25	5 Years	1,074.73	12 Mos.	1,602.25
1936	Timber Construction	7,917.28	6 Years	—0—	6 Mos.	237.52
1934	Field Equipment	6,384.70	10 Years	638.48	12 Mos.	638.48
1934	Drilling Equipt.	22,624.03	3 Years	3,770.67	12 Mos.	7,541.34
1936	Drilling Equipt.	92,440.34	4 Years	—0—	7.2 Mos.	13,866.05
1936	Steel Derrick	14,261.98	5 Years	—0—	3.6 Mos.	855.72
1934	Truck	606.25	2 Years	303.12	12 Mos.	303.13
	Totals	$282,563.65		$7,179.41		$33,070.42

[fol. 32]

Exhibit "E" to Petition

Depreciation

Fiscal Year Ended February 28, 1938

(Schedule Continued on Following Page)

Line	Date Acquired	Property	Cost	Depreciation Prior Years
1	1933-'34	Casing, Tubing & Screen	$24,709 67	$6,608 89
2	1936	Casing, Tubing & Screen	105,608 09	15,841 22
3	1936-'37	Casing, Tubing & Screen	16,539 62	826 98
4	1937-'38	Casing, Tubing & Screen	3,530 98	—0—
5		Totals—Casing, Tubing & Screen	$150,388 36	$23,277 09
6	1933-'34	Timber Construction	$8,011 25	$3,447 70
7	1936	Timber Construction	7,917 28	1,029 25
8		Totals—Timber Construction	$15,928 53	$4,476 95
9	1934	Field Equipment	$6,384 76	$1,915 44
10	1936-'37	Field Equipment	39,929 01	3,992 09
11	1936-'37	Field Equipment	10,786 09	1,078 61
12	1936-'37	Field Equipment	51,594 27	2,579 71
13	1937-'38	Field Equipment	37,056 62	—0—
14		Totals—Field Equipment	$145,750 75	$9,566 66
15	1934	Drilling Equipment	$22,624 03	$16,410 69
[fol. 33]				
16	1936	Drilling Equipment	92,440 34	36,976 13
17		Totals—Drilling Equipment	$115,064 37	$53,386 82
18	1936	Steel Derricks	$14,261 98	$2,154 26
19	1937-'38	Steel Derricks	1,722 69	—0—
20		Totals—Steel Derricks	$15,984 67	$2,154 26
21		Totals	$443,116 68	$92,861 78

Depreciation
Fiscal Year Ended February 28, 1938
(Continuation of Schedule from Preceding Page)

Line From Preceding Page	Remaining Cost	Estimated Remaining Life—Beginning of Year	Depreciation Year Ended 2/28/38 Time	Amount
1	$18,100.78	7 Years	12 Mos.	$2,585 83
2	89,766.87	8½ Years	12 Mos.	10,560 81
3	15,712.64	9½ Years	12 Mos.	1,653 96
4	3,530.98	10 Years	6 Mos.	176 55
5	$127,111.27			$14,977 15
6	$4,563.55	3 Years	12 Mos.	$1,521 18
7	6,888.03	4 Years	12 Mos.	1,722 01
8	$11,451.58			$3,243 19
9	$4,469.32	7 Years	12 Mos.	$638 48
10	35,936.11	9 Years	12 Mos.	3,992 90
11	9,707.48	9 Years	12 Mos.	1,078 61
[fol. 34]				
12	49,014.56	9½ Years	12 Mos.	5,159 43
13	37,056.62	10 Years	6 Mos.	1,852 83
14	136,184.09			$12,722 25
15	$6,213.24	1 Year	12 Mos.	$6,213 34
16	55,464.21	28.8 Mos.	12 Mos.	23,110 08
17	$61,677.55			$29,323 42
18	$12,107.72	44.4 Mos.	12 Mos.	$3,272 36
19	1,722.69	5 Years	12 Mos.	344 54
20	$13,830.41			$3,616 90
21	$350,254.90			$63,882 91

Before United States Board of Tax Appeals

Answer—Filed May 29, 1942

Comes now the Commissioner of Internal Revenue, by his attoreny, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein admits and denies as follows:

1, 2, and 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

[fol. 35] 4-(a) to (j), inclusive. Denies the allegations contained in paragraphs 4-(a) to (j), inclusive, of the petition.

5-(a). Denies the allegations contained in paragraph 5-(a) of the petition.

5-(b). Admits that during the taxable year ended February 29, 1936, the petitioner paid to the Gulf Refining Company $17,406.19; denies the remaining allegations in paragraph 5-(b) of the petition.

5-(c). Denies the allegations contained in paragraphs 5-(c) of the petition.

5-(d). Admits that during the taxable year ended February 28, 1937, the petitioner paid to the Gulf Refining Company the sum of $232,498.94; denies the remaining allegations in paragraph 5-(d) of the petition.

5-(e). Denies the allegations contained in paragraph 5-(e) of the petition.

5-(f). Admits that the Commissioner in his ninety-day letter determined that the amount of $27,564.61 was incurred in connection with litigation covering a large tract of land, and that the expenditure of said amount was in defending and protecting title to the property, and as such, said expenditures are specifically excluded from allowable deductions under the regulations of said Commissioner of Internal Revenue; denies the remaining allegations in paragraph 5-(f) of the petition.

5-(g) and (h). Denies the allegations contained in paragraphs 5-(g) and (h) of the petition.

[fol. 36] 5-(i). Admits that during the taxable year ended February 28, 1938, the petitioner paid to the Gulf Refining Company the sum of $286,128.23; denies the remaining allegations in paragraph 5-(i) of the petition.

5-(j). Denies the allegations contained in paragraph 5-(j) of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the appeal be denied.

(Signed) J. P. Wenchel, H J F (J. P. Wenchel),
Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, Division Counsel; Homer J. Fisher, Special Attorney, Bureau of Internal Revenue.

HJF:mmd. 5/25/42.

[fol. 37] IN THE TAX COURT OF THE UNITED STATES

[Title omitted]

RESPONDENT'S COMPUTATION FOR ENTRY OF DECISION—Filed September 4, 1944

The attached proposed computation is submitted on behalf of the respondent to the Tax Court of the United States, in compliance with its opinion determining the issues in this proceeding.

This computation is submitted in accordance with the opinion of the Tax Court, without prejudice to the respondent's right to contest the correctness of the decision entered herein by the Tax Court, pursuant to the statutes in such cases made and provided.

(Signed) J. P. Wenchel, J. L. B. (J. P. Wenchel), Chief Counsel, Bureau of Internal Revenue.

Of Counsel: James L. Backstrom, Division Counsel; Frank B. Schlosser, Special Attorney, Bureau of Internal Revenue.

FBS:mjh.

[fol. 38] Recomputation

H-TC:Recomp.
H-FC:Recomp.
LMF.

In re: Burton-Sutton Oil Company, Incorporated
Lake Charles, Louisiana

Docket: #110566

Income Tax

Year Fiscal ended:	Liability	Assessed	Deficiency
February 29, 1936	$20,698.31	$9,899.30	$10,799.01
February 28, 1937	89,129.23	23,020.28	66,108.95
February 28, 1938	71,120.43	9,742.00	61,378.43

Excess-Profits Tax

February 29, 1936	$1,073.77	$406.35	$667.42
February 28, 1937	36,166.67	8,364.49	27,802.18
February 28, 1938	23,859.15	637.36	23,221.79

Fiscal Year Ended February 29, 1936

Net income as shown in the deficiency notice dated January 16, 1942	$150,533.19
As adjusted in accordance with the decision of The Tax Court of the United States	$150,533.19
Adjustments	None

[fol. 39] Computation of Tax

Year	Liability	Assessed	Deficiency
Excess-Profits Tax:			
Excess-profits tax liability as shown in the deficiency notice (No change made by the Tax Court)			$1,073.77
Excess-profits tax assessed:			
Original account #400030		None	
Additional, Jan. 1940 list, account #521207		$406.35	406.35
Deficiency of excess-profits tax			$667.42
Income Tax:			
Income tax liability as shown in the deficiency notice (No change made by The Tax Court)			$20,628.31
Income tax assessed:			
Original account #400030		$16,819.32	
Additional, Jan. 1940 list, account #521207		1,485.64	
Total		$18,304.96	
Less: Previous allowance		8,405.66	9,899.30
Deficiency of income tax			$10,799.01

Fiscal Year Ended February 28, 1937

Net income as shown in the deficiency notice dated January 16, 1942	$314,703.01
As adjusted in accordance with the decision of The Tax Court of the United States	$313,888.90
Deduction:	
1. Additional accrued taxes allowable	$814.11

[fol. 40] Explanation of Adjustment

1. The Tax Court of the United States holds that the amount of $814.11 asserted and paid in 1940 represents taxes accrued in 1937, and as such is an allowable deduction from gross income for 1937, under section 23(c) of the Revenue Act of 1936. This item was not allowed in the deficiency notice.

Computation of Tax

Excess-Profits Tax:

Taxable net income		$313,888.90
Less: 10% of $100,000.00, value of capital stock as declared in capital stock tax return for the year ended June 30, 1936		10,000.00
Net income subject to excess-profits tax		$303,888.90
Tax on $5,000.00 (5% of $100,000) at 6%		$300.00
Tax on $298,888.90 at 12%		35,866.67
Excess-profits tax liability		$36,166.67
Excess-profits tax assessed:		
Original account #853032	None	
Additional, May 26, 1939, #4 list, page 9, line 0	$8364.49	8,364.49
Deficiency of excess-profits		$27,801.18

Income Tax:

Normal Tax:	
Taxable net income	$313,888.90
Less: Excess-profits tax	36,166.67
Net income for normal tax computation	$277,722.23

[fol. 41]

Tax on $2,000.00 at 8%		$160.00
Tax on 13,000.00 at 11%		1,430.00
Tax on 25,000.00 at 13%		3,250.00
Tax at 237,722.23 at 15%		35,658.33
Total normal tax		$40,498.33

Surtax on Undistributed Profits:

Taxable net income		$313,888.90
Less:		
Excess-profits tax	$36,166.67	
Normal tax	40,498.33	76,665.00
Adjusted net income		$237,223.90
Undistributed net income		$237,223.90
Tax on $23,722.39 at 7%		$1,660.57
Tax on 23,722.39 at 12%		2,846.69
Tax on 47,444.78 at 17%		8,065.61
Tax on 47,444.78 at 22%		10,437.85
Tax on 94,889.56 at 27%		25,620.18
Total surtax		$48,630.90
Total normal tax		40,498.33
Income tax liability		$89,129.23
Income tax assessed:		
Original account #853032	None	
Additional, May 26, 1939, #4 list, page 0, line 0	$23,020.28	23,020.28
Deficiency of income tax		$66,108.95

[fol. 42] Fiscal Year Ended February 28, 1938

Net income as shown in the ninety-day letter dated January 16, 1942	$320,598.27
As adjusted in accordance with the decision of The Tax Court of the United States	$246,041.47

Deductions:

1. Additional depletion allowable	$45,754.36	
2. Additional accrued taxes allowable	1,237.83	
3. Legal expenses	27,564.61	$74,556.80

Explanation of Adjustments

1. In accordance with the Tax Court's opinion, the depletion deduction allowed in the deficiency notice of $240,373.87 is increased by $45,754.36 to $286,128.23, the amount stipulated by both parties as the correct amount allowable.

2. The Tax Court of the United States holds that the amount of $1,237.83 asserted and paid in 1940 represents taxes accrued in 1938, and as such is an allowable deduction from gross income for 1938 under section 23(c) of the Revenue Act of 1936. This item was not allowed as a deduction in the deficiency notice.

3. The Tax Court of the United States holds that the amount of $27,564.61 expended by petitioner in resisting certain condemnation proceedings is deductable as an ordinary and necessary business expense. None allowed in the deficiency notice.

[fol. 43] Adjustment to Declared Value of Capital Stock

Value of capital stock as declared in capital stock tax return for the year ended June 30, 1927	$238,474.46
Increase in net income for normal tax computation for the fiscal year ended February 28, 1937	139,247.77
Value as adjusted	$377,722.23

Explanation of Adjustment

Net income for normal tax computation as adjusted	$277,722.23
Net income per return	138,474.46
Increase as above	$139,247.77

Computation of Tax

Excess-Profits Tax:

Taxable net income		$246,041.47
Less: 10% of $377,722.23, adjusted value of capital stock as shown above		37,772.22
Net income subject to excess-profits tax		$208,269.25
Tax on $18,886.11 (5% of $377,722.23) at 6%		$1,133.17
Tax on $189,383.14 at 12%		22,725.98
Excess-profits tax liability		$23,859.15
Excess-profits tax assessed:		
Original account #852959	None	
Additional, May 26, 1939, #4 list, page 0, line 2	$637.36	637.36
Deficiency of excess-profits tax		$23,221.79

[fol. 44]

Income Tax:

Normal Tax:		
Taxable net income		$246,041.47
Less: Excess-profits tax		23,859.15
Net income for normal tax computation		$222,182.32
Tax on $2,000.00 at 8%		$160.00
Tax on 13,000.00 at 11%		1,430.00
Tax on 25,000.00 at 13%		3,250.00
Tax on 182,182.32 at 15%		27,327.35
Total normal tax		$32,167.35

Surtax on Undistributed Profits:

Taxable net income		$246,041.47
Less:		
Excess-profits tax	$23,859.15	
Normal tax	32,167.35	56,026.50
Adjusted net income		$190,014.97
Undistributed net income		$190,014.97
Tax on $19,001.50 at 7%		$1,330.11
Tax on 19,001.50 at 12%		2,280.18
Tax on 38,002.99 at 17%		6,460.51
Tax on 38,002.99 at 22%		8,360.66
Tax on 76,005.99 at 27%		20,521.62
Total surtax		$38,953.08
Total normal tax		32,167.35
Income tax liability		$71,120.43

[fol. 45]

Income tax assessed:

Original account #852959	None	
Additional, May 26, 1939, #4 list, page 0, line 2	$9,742.00	9,742.00
Deficiency of income tax		$61,378.43

IN THE TAX COURT OF THE UNITED STATES

STIPULATION OF FACTS—Filed at Hearing October 25, 1943

It is agreed by and between the parties to the above-entitled and numbered cause of action that the following facts shall be taken as true, subject, however, to the right of either party to introduce in evidence other and additional facts not inconsistent with the facts herein agreed to.

1

The petitioner is a corporation organized in February 1933 and doing business under the laws of the State of Louisiana with its principal office in Lake Charles, Lou-

isiana. The returns for the periods here involved were filed with the Collector of Internal Revenue for the District of Louisiana, said Collector's office being located at New Orleans, Louisiana. Petitioner kept its books and prepared its income tax return on the accrual basis.

2

On or about February 27, 1933, petitioner acquired from J. G. Sutton a contract which had been entered into be-
[fol. 46] tween the Gulf Refining Company of Louisiana and J. G. Sutton on February 18, 1933, reading as follows:

THE STATE OF TEXAS,
County of Harris:

Know All Men by These Presents: That, Gulf Refining Company of Louisiana, hereinafter styled "Grantor", for and in consideration of Ten Dollars ($10.00) and other valuable Considerations to it in hand paid by J. G. Sutton, receipt of which is hereby acknowledged, has sold, conveyed and transferred, and does hereby sell, convey and transfer unto the said J. G. Sutton, hereinafter styled "Grantee", all oil and gas rights, titles, interests or privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of Section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.

This assignment is made subject to the following terms and conditions:

1. Grantee binds and obligates himself to begin on or before thirty days from date, operations for the drilling of a well on said land and to continue his operations thereon with reasonable diligence to completion or abandonment in an honest, bona fide effort to find oil or gas in paying quantities on said land. After the completion of said well, Grantee shall continue such operations on said land as may be necessary to continue said lease in full force and effect. If, after completing said well, Grantee shall desire to cease operations on said land, he shall, upon demand, reassign said lease to Grantor not less than thirty days prior to the maturity date of any obligation accru-

ing after the date of the cessation of his operations on said land.

[fol. 47] 2. All oil and gas royalties which are due and payable under the terms of said lease herein referred to, as well as the overriding oil royalty provided for in the contract executed by Gulf Refining Company of Louisiana to S. W. Sweeney, on April 7, 1927, together with all the costs and expenses incurred by Grantee in his operations on said land, shall be borne and paid by Grantee, out of the remainder of the proceeds of the sale of any oil and/or gas produced from the land, after payment of the royalties hereinabove provided for, Grantee shall reimburse himself for the costs and expenses incurred and allowed by reason of his operations under said lease.

3. After Grantee has met the underlying and overriding royalty obligations referred to in paragraph 2 hereof and has been reimbursed out of the proceeds of the oil and gas produced from all such costs and expenses of operating upon said property as defined below, Grantee shall account to and pay Grantor 50% of the remaining portion of said proceeds of the oil and/or gas produced and sold from the said land. Accounting hereunder shall be at the price which Grantee received for the oil and/or gas produced from said land.

4. Accounting and settlement under this agreement shall be made at the end of each calendar month, and losses and arrears sustained by Grantee in his operations may be brought forward from month to month until extinguished. This provision shall apply to the cost of all drilling operations hereunder, including the cost of the first well herein provided for. If, within sixty days from the date of any settlement, it should develop that any error has been made in the statement upon which settlement is based, either by including erroneous charges or by omitting proper charges, then prompt adjustment shall be made; provided, Grantor shall never be required to reimburse Grantee for more than Grantor received at the time such settlement was made.

[fol. 48] Grantee shall have the right to retain and maintain out of the profits accruing from his operations the sum of Twenty-Five Thousand Dollars ($25,000.00) to cover the costs and expenses of operations during the next

succeeding calendar month; provided, that if Grantee should cease drilling operations for three consecutive months, then Grantor shall have the right to demand and receive from Grantee one-half of said sum so retained and maintained.

5. The costs and expenses allowed in this agreement and that may be deducted by Grantee from the proceeds of the Gross production of oil and gas from said land before a payment shall be made to Grantor shall consist of the following only, to-wit:

(a) The oil and gas royalty provided for in the original lease from Cameron Parish School Board to Gulf Refining Company of Louisiana above referred to, and the overriding oil royalty provided for in agreement between Gulf Refining Company of Louisiana, and S. W. Sweeney above referred to.

(b) The cost, repair, up-keep and maintenance of all material, machinery, equipment and property of every kind devoted exclusively to the development of and use upon the property covered by said lease, including employer's liability, derrick insurance, storage tanks, and drilling rig cost or rental, the said rig rental not to exceed $1,000.00 per month.

(c) The cost of all labor, whether clerical, common labor, or executive services devoted exclusively to operations upon or in connection with said property.

(d) The cost of treating to make marketable any oil produced hereunder.

[fol. 49] (e) The cost of properly disposing of salt water and in settling claims for damages arising from salt water.

(f) A charge for overhead equal to five per cent (5%) of the amount of money spent every month by Grantee under subdivision (c) hereof, said charge not to exceed $1,000.00 per month.

(g) All severance, ad valorem and other taxes of whatever kind levied against or on the oil and gas produced.

(h) A fair proportion of the salaries of any field superintendent, warehousemen or timekeepers employed in connection with the land herein described and other properties, based upon the gross expenditures on the property herein referred to in their ratio to the gross expenditures on other properties operated by Grantee in the said field.

(i) Reimbursement for all damages actually paid by Grantee arising from whatever cause in the course of operations under this contract, less and except those damages against which Grantee is protected by insurance, or otherwise.

6. Grantee shall keep accurate accounts of all expenses incurred in the operation of the property and all records relating to the expenses of such operations shall be accessible to Grantor at all reasonable times. Grantee shall at the end of each calendar month furnish to Grantor a full and complete statement showing all expenditures made by Grantee in connection with his operations on said land.

7. In no event shall Grantor be obligated to pay any of the costs or expenses incurred by Grantee in his operations under this agreement; nor shall it ever be called upon or required to repay to Grantee any sum paid to [fol. 50] Grantor at any subsequent period because of any arrears or losses incurred by reason of any subsequent losses.

8. It is understood and agreed that all sulphur rights and all rights to produce sulphur under and by virtue of the said lease herein referred to have been and are still reserved to Grantor, which shall have the exclusive right to enter upon the land for the production of sulphur therefrom. In the exercise of such rights the said Grantor shall have due regard for the rights of Grantee under this contract and shall so conduct its operations for the production of sulphur as to interfere with the operations of Grantee as little as possible. In no event, shall the operations for the production of sulphur interfere with operation on any well drilled by Grantee so long as it is producing oil in paying quantities.

9. Grantor shall have the right to purchase the oil produced from said land by paying therefor the average posted price paid for oil of like grade and gravity in the Coastal Oil Fields in Southwest Louisiana. The right to purchase shall be exercised in writing within thirty days after Grantee notifies Grantor that production in paying quantities has been secured and when exercised shall cover the next succeeding three calendar months; thereafter, Grantor shall continue to purchase said oil for like three months' periods until it gives Grantee at least thirty days notice

before the end of any such period of Grantor's intention to cease doing so. Grantee shall thereupon make such sales of said oil as Grantee may desire, but all sales by Grantee shall be upon the price basis herein set out, and no contract shall be made by him for the sale of said oil for a longer period than the next succeeding six months. Sixty days before the expiration of any contract that Grantee may make for the sale of the said oil, Grantee shall notify Grantor, and unless Grantor shall notify Grantee within thirty days of Grantor's desire to purchase said oil as [fol. 51] above provided, then Grantee shall have the right to contract for the sale of said oil as above set out. This plan shall be pursued during the life of this agreement.

Executed in Duplicate This the 18th day of February, 1933.

Gulf Refining Company of Louisiana, (Signed) by Underwood Nazro, Vice-President, (Signed) J. G. Sutton.

Attest:

L. E. Helenz, Asst. Secretary.

3

Shortly after acquisition petitioner, pursuant to terms of the above contract proceeded to the development and operation of the property and obtained oil and/or gas in paying quantities. In accordance with the provisions of paragraph 3 of the contract, the following sums were paid to the Gulf Refining Company of Louisiana during the taxable years indicated:

1936	$ 17,406.19
1937	232,498.94
1938	286,128.28

The foregoing amounts were claimed as deductions in the returns filed for the respective years. Respondent in his notice of deficiency has disallowed said deductions on the ground that the amounts paid to Gulf Refining Company represent additional costs of the property covered by the contract, recoverable through depletion allowances. [fol. 52] Depending upon the Board's final decision the allowable depletion will be determined under Rule 50.

4

Under date of November 27, 1940, the Department of Revenue of the State of Louisiana sent the petitioner a notice of an additional corporation franchise tax due for the taxable year ended February 28, 1937. This additional amount of franchise tax was paid by the petitioner on November 30, 1940. The Commissioner has failed and refused to allow this $814.11 as a deduction from the petitioner's income for the period ended February 28, 1937.

5

Under date of December 31, 1941 the Office of the Department of Revenue for the State of Louisiana asserted against petitioner additional income taxes for the fiscal year ended February 28, 1937 in the total amount of $15,025.42 and interest in the amount of $3,305.59. The petitioner, within the ninety-day period filed an appeal from this assertion of additional taxes with the Board of Tax Appeals of the State of Louisiana. That appeal is now pending and has not been decided. The Commissioner failed and refused to allow the petitioner deduction of either the $15,025.42 of addition tax or the $3,305.59 additional interest as deductions in the computation of petitioner's income and excess profits tax liability for the taxable year ended February 28, 1937.

6

During the taxable year ended February 28, 1938 the petitioner expended $27,564.61 legal expenses in resisting proceedings instituted by the United States of America [fol. 53] on certain of its property. The petitioner had possession of the property for a period of years, had developed the property, obtained production of oil and was deriving a large income therefrom.

7

Under date of November 27, 1940 the Department of Revenue of the State of Louisiana asserted against the petitioner additional corporation franchise taxes in the amount of $1,237.83 for the taxable year ended February 28, 1938. This tax was paid on November 30, 1940. The Commissioner of Internal Revenue has failed and refused

to allow this $1,237.83 as an allowable deduction in the computation of petitioner's income and excess profits tax liability for the taxable year ended February 28, 1938.

8

On December 31, 1941 the Department of Revenue for the State of Louisiana mailed to the petitioner a ninety-day letter asserting additional income taxes in the amount of $15,750.00 and additional interest in the amount of $2,520.00 for the fiscal year ended February 28, 1938. Within the ninety-day period the petitioner effected an appeal from the assertion of this additional taxes for the fiscal year ended February 28, 1938, and that appeal is now pending in said Board of Tax Appeals undisposed of. The Commissioner of Internal Revenue has failed and refused to allow the petitioner a deduction of either the $15,750.00 additional tax for said taxable year or the $3,150.00 additional interest for said year as a deduction in computing the petitioner's income and excess profits tax liability for the taxable year ended February 28, 1938.

[fol. 54]

9

For the fiscal year ended February 28, 1938, the respondent allowed depletion in the amount of $240,373.87. During this same fiscal year the petitioner paid the Gulf Refining Company under the contract set out in paragraph 2 hereof the sum of $286,128.23. If this Court does not permit the petitioner to eliminate from its taxable income the payment of $286,128.23, then the petitioner is entitled to an additional deduction for depletion in the fiscal year ended February 28, 1938 in the amount of $45,754.36.

Wright Matthews, Counsel for Petitioner, (Sgd.) J. P. Wenchel, JLB, (J. P. Wenchel), Chief Counsel, Bureau of Internal Revenue, Counsel for Respondent.

IN THE TAX COURT OF THE UNITED STATES

BURTON-SUTTON OIL COMPANY, INCORPORATED, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 110566. Promulgated August 4, 1944.

1. Petitioner acquired an oil and gas lease by assignment and contracted with the assignor among other things that "After Grantee has met the underlying and overriding royalty obligations referred to in paragraph 2 hereof and has been reimbursed out [fol. 55] of the proceeds of the oil and gas produced from all such costs and expenses of operating upon said property as defined below, Grantee shall account to and pay Grantor 50% of the remaining portion of said proceeds * * *." During the taxable years 1936, 1937 and 1938 it paid the grantor of the contract certain amounts representing the "50% of the remaining portion of said proceeds" called for in the contract. *Held*, the amounts so paid to the grantor are capital expenditures and represent a part of the cost of the lease to petitioner and are not to be excluded from petitioner's income except through deductions for depletion or as a part of the cost basis in case of a sale or other disposition of the property. *Quintana Petroleum Company*, 44 B. T. A. 624, affd. — Fed. (2d) —, followed.

2. In 1940, the State of Louisiana asserted against petitioner additional corporation franchise taxes for the taxable years 1937 and 1938 which petitioner paid in 1940. Petitioner kept its books upon the accrual basis. *Held*, the amounts asserted and paid in 1940 represented taxes accrued in 1937 and 1938, respectively, and as such were allowable deductions from gross income for the years 1937 and 1938 under section 23(c) of the Revenue Act of 1936.

3. In 1941, the State of Louisiana asserted against petitioner additional income taxes for the taxable years 1937 and 1938, together with interest thereon, all of which petitioner is contesting before the Board

of Tax Appeals of that State. *Held*, petitioner is not entitled to deduct any of these contested items from its gross income for the taxable years 1937 and 1938, respectively. *Dixie Pine Products Company* v. *Commissioner*, 320 U. S. 516.

[fol. 56] 4. During the taxable year 1938, petitioner expended a sum of money in resisting certain condemnation proceedings instituted by the United States which involved among other things a dispute over the boundaries of petitioner's property. The dispute was settled in petitioner's favor. *Held*, the expenditures in question are deductible as ordinary and necessary business expenses: *L. B. Reakirt*, 29 B. T. A. 1296, affd. *per curiam* 84 Fed. (2d) 996, followed.

Wright Matthews, Esq., for the petitioner.

Frank B. Schlosser, Esq., and *L. R. Van Burgh, Esq.* for the respondent.

This proceeding involves the determination by the respondent against petitioner of deficiencies in income and excess profits taxes for the taxable years 1936, 1937 and 1938 in amounts as follows:

Fiscal Year Ending	Income Tax	Excess Profits Tax
February 29, 1936	$10,799.01	$ 667.42
February 28, 1937	66,341.26	27,899.87
February 28, 1938	82,655.94	32,157.86

The above deficiencies result from several adjustments to the net income as reported by petitioner. Not all of these adjustments are contested. Some of the adjustments that were contested by appropriate assignments of error were abondoned at the hearing without prejudice to petitioner's right to raise similar issues in future years. These abandoned issues relate to claimed deductions for depreciation for 1936 and 1938, and claimed deductions for timber used for construction purposes in 1937 and 1938. Additional errors were assigned by petitioner relating to certain claimed deductions for state franchise and state [fol. 57] income taxes together with interest on the income taxes concerning which no adjustments were made by the respondent. The issues which have thus been raised by

appropriate assignments of error and remaining for our determination and decision are as follows:

1. Is petitioner entitled to exclude from taxable income in each of the taxable years the amount paid to the Gulf Refining Company of Louisiana under the terms of a contract whereby petitioner acquired an oil and gas lease?

2. Is petitioner entitled to deduct in the taxable years 1937 and 1938 the amounts of additional franchise taxes for those years which were asserted by the State of Louisiana in the year 1940 and paid by petitioner in 1940?

3. Is petitioner entitled to deduct in the taxable years 1937 and 1938 amounts representing additional state income taxes, together with interest thereon, which were asserted for those years by the State of Louisiana on December 31, 1941, where an appeal has been taken to the Board of Tax Appeals of the State of Louisiana and the additional taxes and interest have not been paid?

4. Is the sum of $27,564.61 paid in the taxable year 1938 for legal services rendered in connection with a condemnation suit brought against petitioner and others, by the United States, which involved the boundary lines to petitioner's property, deductible as an ordinary and necessary expense?

Findings of Fact

Petitioner is a corporation organized in February 1933 and doing business under the laws of the State of Louisiana with its principal office in Lake Charles, Louisiana. The returns for the taxable years here involved were filed [fol. 58] with the collector of internal revenue for the District of Louisiana at New Orleans. Petitioner kept its books and prepared its returns on the accrual basis.

Issue No. 1. The adjustments to petitioner's net income for the years 1936, 1937 and 1938, which resulted in assignments of error raising Issue No. 1 were explained by the respondent in the statement attached to the deficiency notice as follows:

> It is held that payments made to Gulf Refining Company of Louisiana in each of the years 1936, 1937 and 1938 in accordance with the contract whereby you acquired the lease to a section of State school

land in Cameron Parish, Louisiana, represent a part of the cost of that lease, and are therefore not to be deducted or excluded from taxable income, except as they are recovered through depletion. Since in each of the years under consideration percentage depletion is greater than depletion based on cost of the lease, adjusted for depletion previously allowed, percentage depletion has been allowed in each year.

On or about February 27, 1933, petitioner acquired from J. G. Sutton a contract which had been entered into on February 18, 1933 between Sutton as "Grantee" and the Gulf Refining Company of Louisiana hereinafter sometimes referred to as "Gulf" or as "Grantor". This contract recited that Gulf for and in consideration of $10 and other valuable considerations "has sold, conveyed and transferred, and does hereby sell, convey and transfer" unto the said Grantee "all oil and gas rights, titles, interests or privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of Section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Lou- [fol. 59] isiana Meridian, in Cameron Parish, Louisiana." The contract further recited that:

> This assignment is made subject to the following terms and conditions:
>
> 1. Grantee binds and obligates himself to begin on or before thirty days from date, operations for the drilling of a well on said land and to continue his operations thereon with reasonable diligence to completion or abandonment in an honest, bona fide effort to find oil or gas in paying quantities on said land. After the completion of said well, Grantee shall continue such operations on said land as may be necessary to continue said lease in full force and effect. If, after completing said well, Grantee shall desire to cease operations on said land, he shall, upon demand, reassign said lease to Grantor not less than thirty days prior to the maturity date of any obligation accruing after the date of the cessation of his operations on said land.

2. All oil and gas royalties which are due and payable under the terms of said lease herein referred to, as well as the overriding oil royalty provided for in the contract executed by Gulf Refining Company of Louisiana to S. W. Sweeney, on April 7, 1927, together with all the costs and expenses incurred by Grantee in his operations on said land, shall be borne and paid by Grantee, out of the remainder of the proceeds of the sale of any oil and or gas produced from the land, after payment of the royalties hereinabove provided for, Grantee shall reimburse himself for the costs and expenses incurred and allowed by reason of his operations under said lease.

[fol. 60] 3. After Grantee has met the underlying and overriding royalty obligations referred to in paragraph 2 hereof and has been reimbursed out of the proceeds of the oil and gas produced from all such costs and expenses of operating upon said property as defined below, Grantee shall account to and pay Grantor 50% of the remaining portion of said proceeds of the oil and or gas produced and sold from the said land. Accounting hereunder shall be at the price which Grantee received for the oil and/or gas produced from said land.

4. Accounting and settlement under this agreement shall be made at the end of each calender month, and losses and arrears sustained by Grantee in his operations may be brought forward from month to month until extinguished. • • •

Paragraph 5 of the contract specified what "costs and expenses allowed in this agreement and that may be deducted by Grantee from the proceeds of the Gross production of oil and gas from said land before a payment shall be made to Grantor". Paragraph 6 provided that the Grantee shall keep accurate accounts and furnish the Grantor with a complete statement at the end of each month. Paragraph 7 provided that in no event shall the Grantor be obligated to pay any of the costs or expenses incurred by the Grantee in his operations under the agreement. Under paragraph 8 "It is understood and agreed that all sulphur rights and all rights to produce sulphur under and by virtue of the said lease herein referred to

have been and are still reserved to Grantor * * *." The final paragraph was numbered 9 and provided for the manner in which the oil produced from the land was to be sold wherein the Grantor was given the right to purchase such oil at the average posted price if it so desired. [fol. 61] Shortly after acquisition of the contract petitioner, pursuant to the terms thereof, proceeded to the development and operation of the property and obtained oil and/or gas in paying quantities. In accordance with the above provisions of paragraph 3 of the contract, the following sums were paid to Gulf during the taxable years indicated:

1936	$ 17,406.19
1937	232,498.94
1938	286,128.28

The foregoing amounts were claimed as deductions in the returns filed for the respective years which were disallowed by the respondent in his notice of deficiency on the ground that the amounts paid Gulf represented additional costs of the property covered by the contract and which were recoverable through depletion allowances. The parties have stipulated that depending upon our final decision as to this issue "the allowable depletion will be determined under Rule 50".

Issue No. 2. Under date of November 27, 1940, the Department of Revenue of the State of Louisiana asserted against petitioner additional corporation franchise taxes in the amounts of $814.11 and $1,237.83 for the taxable years 1937 and 1938, respectively. These taxes were paid on November 30, 1940. The respondent has failed and refused to allow these amounts as allowable deductions in the computation of petitioner's income and excess profits tax liabilities for the taxable years in question.

Issue No. 3. Under date of December 31, 1941, the Office of the Department of revenue for the State of Louisiana asserted against petitioner additional income taxes for the taxable years 1937 and 1938 in the amounts of $15,025.42 [fol. 62] and $15,750, respectively, and interest thereon in the amounts of $3,305.59 and $2,520, respectively. Petitioner contested these assertions and filed an appeal with the Board of Tax Appeals of the State of Louisiana. At

the time of the hearing in the present proceeding that appeal was still pending and had not been decided. The respondent has failed and refused to allow any of the above amounts as deductions from gross income for the taxable years 1937 and 1938, respectively.

Issue No. 4. The adjustment to petitioner's net income for the fiscal year ending February 28, 1938, which resulted in the assignment of error raising Issue No. 4 was explained in the statement attached to the deficiency notice as follows:

> (a) The legal expenses incurred by you in connection with litigation covering a large tract of land within which is included the land on which you were conducting oil operations, are held to have been expended in defending and perfecting your title to the property, and as such, are specifically excluded from allowable deductions by article 24-2 of Regulations 94.

On July 19, 1937, the United States of America filed At Law No. 2841 a petition for condemnation in the District Court of the United States for the Western District of Louisiana, Lake Charles Division against "139,248.68 acres, more or less, of land in Cameron Parish Louisiana; Orange Cameron Land Company, Inc., a Texas corporation, et al., Defendants." Petitioner was made a defendant in this suit under paragraph 11 of the petition which was as follows:

> 11. The said defendants generally and all and singular the heirs, executors, administrators, representatives [fol. 63] of each and every of the above named persons; and all unknown owners, lienors, and claimants having or claiming any right, title, estate, equity, interest or lien; and all occupants, lessees, licensees and users and holders and owners of, and claimants to easements in, on, over or through said lands; and all persons, firms and corporations claiming any title or interest to or in any of said tracts of land; are made parties defendant to the end that they may come into Court and by proper pleadings make claim to said lands, or to the proceeds arising therefrom.

Petitioner's interest in this suit as a party defendant came about in the following manner. The land being condemned was to be used as a Federal bird preserve under

the jurisdiction of the United States Department of Agriculture, and took in several townships (except Section 16 in each township which was owned by the State) in Cameron Parish, Louisiana, between Sabine Lake on the West and Calcasieu Lake on the East and from about five miles north of the Gulf of Mexico to about 14 miles North thereof. The lease which petitioner acquired on or about February 27, 1933 and which is involved in Issue No. 1 herein was in this territory, and being a lease covering all of the whole of "Section Sixteen", Township 14 South, Range 13 West, Louisiana Meridian would have been exempt from the condemnation if there had been no dispute as to the location of said Section 16, which dispute is more fully explained below. From the time petitioner acquired this lease in 1933 up to the time the condemnation suit was filed in 1937, petitioner had drilled about 19 producing wells on the land, and petitioner's gross income therefrom was something over $1,000,000 a year for the fiscal years 1937 and 1938.

The Bureau of Biological survey of the Department of Agriculture made a survey of the 139,000 acres preparatory [fol. 64] to acquiring the land. Early in 1936 petitioner learned that the survey made by the Bureau of Biological Survey had the effect of moving all north and south section lines in Township 14 South, Range 13 West, about three miles to the west. This would have had the effect of leaving the oil field which petitioner had developed in what it contended was Section 16 in a section three miles to the east.

Petitioner then employed the law firm of Cline, Thompson and Lawes to represent it in connection with this controversy. Protests and arguments were made as to the incorrectness of the Bureau's survey which resulted in a resurvey, and on the second survey it was proposed to move the lines about ¾ths of a mile to the west, which still had the effect of placing the land on which petitioner's oil field had been developed in Section 15 of that Township rather than Section 16. The State of Louisiana owns Section 16, subject to the right of the Cameron Parish School Board to lease it for oil and receive the revenue from it. The School Board under its lease with petitioner which is described in Issue No. 1 herein received a 1/8th royalty.

During the early part of 1936 until the case was concluded in December 1937, W. W. Thompson of the law firm of Cline, Thompson and Lawes did practically no work except that in connection with this condemnation proceeding. This

work consisted of writing briefs, holding many conferences in Washington, Dallas, Galveston, Orange, New Orleans, Shreveport, Baton Rouge, and Lake Charles in efforts to convince the Orange Cameron Land Company principally and the Government, that the Bureau's survey was wrong and that a survey made by F. Shutts Sons in 1924 and 1925 was correct, and that the lines of Section 16 of Township 14 [fol. 65] South, Range 13 West, as established by the Shutts survey formed the correct boundary lines between that Section and the lands of the Orange Cameron Land Company that were being taken by the Government. Finally, a few days before the trial which was fixed for December 13, 1937, at a conference in Washington in the office of the Attorney General at which conference were present representatives of the Bureau of Biological Survey, the State of Louisiana through its Attorney General, Orange Cameron Land Company and others, Thompson was successful in convincing all the interested parties that the section lines as contended for by petitioner were correct and, based upon that agreement, judgment was entered in the case in so far as petitioner was concerned on December 14, 1937.

In the above-mentioned suit there had been no question as to the validity of petitioner's lease with the Cameron Parish School Board. The only question involved in so far as petitioner was concerned was the location of Section 16, Township 14 South, Range 14 West, and the boundaries thereof. If Section 16 were located on the ground where the Bureau of Biological Survey contended it was, petitioner would have a lease on barren prairie land with no production, whereas if it were where petitioner contended it was the lease would be on land with 19 producing wells. If petitioner had lost, it would have lost its entire oil field and the income therefrom. The final judgment placed the boundary of said Section 16 just a- petitioner had contended it should be placed, namely, in accordance with the survey made by Shutts in 1924 and 1925.

During the taxable year ended February 28, 1938, petitioner expended $27,564.61 in legal expenses (including a $25,000 fee to Cline, Thompson and Lawes) in resisting the above-mentioned condemnation proceedings instituted by the United States. On its return for the said taxable year [fol. 66] it deducted this amount as an ordinary and neces-

sary business expense. The respondent disallowed the item for the reasons given above.

Any part of the stipulated facts not included in the foregoing findings of fact are incorporated herein by reference.

OPINION

BLACK, Judge:

We shall consider the issues in the order previously stated.

Issue No. 1. Should the amounts of $17,406.19, $232,498.94 and $286,128.28 paid by petitioner to Gulf during the taxable years 1936, 1937 and 1938, respectively, be excluded from petitioner's income? These amounts were paid pursuant to paragraph 3 of the February 18, 1933, contract between Sutton and Gulf, which contract petitioner acquired from Sutton on or about February 27, 1933. In *Anderson v. Helvering*, 310 U. S. 404, 24 A. F. T. R. 967, the Supreme Court said:

> It is settled that the same basic issue determines both to whom income derived from the production of oil and gas is taxable and to whom a deduction for depletion is allowable. That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest.

The respondent determined and contends that under the contract of February 18, 1933, Gulf sold all of its "oil and gas rights, titles, interests or privileges" in the lease "in consideration of Ten Dollars ($10.00) and other valuable [fol. 67] considerations" part of which consisted of the "50% of the remaining portion of said proceeds of the oil and/or gas produced and sold from the said land" provided for in paragraph 3 of the contract. In other words, the respondent determined and contends that the above amounts paid to Gulf represent a part of petitioner's 'capital investment in the oil and gas in place' and as such should be added to petitioner's cost basis of the lease. On that theory the respondent has included in petitioner's gross income all the income derived by it from the production and sale of oil and gas from the lease, exclusive of the original oil royalty and the overriding oil royalty concerning which there is no dispute, and has allowed petitioner deductions for depletion of "27½ per centum of the gross

income from the property" under section 114(b)(3) of the Revenue Acts of 1934 and 1936.[1]

Petitioner contends that the contract of February 18, 1933, was a sublease rather than a sale; that Gulf retained [fol. 68] an "economic interest" in the oil and gas in place to the extent of the payments required under paragraph 3 of the contract; and that, therefore, the amounts paid to Gulf under paragraph 3 should be excluded from its income. Among the cases cited by petitioner in support of

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[1] The above amounts paid to Gulf, which were determined by the respondent to represent capital expenditures and a part of the cost of the lease, were therefore included as a part of petitioner's "gross income" under section 22 (a) of the Revenue Acts of 1934 and 1936, and as a part of petitioner's "gross income from the property" under section 114 (b) (3) for depletion purposes. Cf. *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 14 AFTR 712; *Sunray Oil Company*, 3 T. C. 251, 254. The above-mentioned deductions for depletion of "27½ per centum of the gross income from the property" were allowed by the respondent for each of the taxable years before us on the ground that the respondent had also determined that such percentage depletion was greater than depletion based on cost under section 114 (b) (1) of the Revenue Acts of 1934 and 1936. The respondent now concedes that if he is correct in his contention that the amounts paid to Gulf represent a part of the cost to petitioner of the lease, then for the year 1938, the depletion based on cost under section 114 (b) (1) is greater than the percentage allowance under section 114 (b) (3), and as a result thereof the parties have stipulated relative to the year 1938 that "If this Court does not permit the petitioner to eliminate from its taxable income the payment of $286,128.23, then the petitioner is entitled to an additional deduction for depletion in the fiscal year ended February 28, 1938 in the amount of $45,754.36." Cf. *North American Oil Consolidated*, 12 B. T. A. 68 (bottom of p. 94 to middle of p. 95), appealed and reversed on other issues, 286 U. S. 417, 11 AFTR 16. On the other hand, if we agree with petitioner that the amounts paid to Gulf should be excluded from petitioner's taxable income, then petitioner's allowance for depletion would have to be redetermined and the parties have stipulated that this may be done under Rule 50.

these contentions are *Thomas* v. *Perkins*, 301 U. S. 655, 19 AFTR 538; *Holly Development Co.* v. *Commissioner*, 93 Fed. (2d) 146, 20 AFTR 393; and *Marrs McLean*, 41 B. T. A. 565, 573-575 (Gray Lease under Issue No. 2), affirmed on other issues, 120 Fed. (2d) 942, 27 AFTR 544.

Respondent relies upon the following cases: *Helvering* v. *O'Donnell*, 303 U. S. 370, 20 AFTR 785; *Helvering* v. *Elbe Oil Land Development Co.*, 303 U. S. 372, 20 AFTR 787; *Blankenship* v. *United States*, 95 Fed. (2d) 507, 20 AFTR 1132; *Anderson* v. *Helvering*, *supra*; and *Quintana Petroleum Company*, 44 B. T. A. 624.

We think the facts in the instant proceeding are practically on all fours with those in *Quintana Petroleum Company*, *supra*, on this issue. In that case respondent relied upon the same authorities as he relies upon here and we sustained him. In that case the pertinent agreement between the parties provided, among other things, as follows:

> • • • If as a result of Trinity's operations on said land, oil and gas should be produced therefrom in paying quantities, then, after paying all of the costs and expenses incurred in drilling, equipping, and operating said well, Trinity shall account to Gulf monthly for one-fourth (¼th) of the net proceeds of such operations. • • •

The agreement then specified the costs and expenses deductible by Trinity in computing the amount of the payments to be made to Gulf Production Co.

[fol. 69] In the instant case paragraph 3 of the agreement by which petitioner was obligated to pay Gulf 50 per cent of the net proceeds after deduction of expenses is in our judgment to all intents and purposes the same as the agreement in the *Quintana Petroleum Company* case, *supra*. As in that case the agreement here was followed by a detailed enumeration of the expenses which were to be deducted by petitioner before there was to be a 50 per cent division of the net proceeds with Gulf. Thus as we have already indicated, we see no distinction in substance between the facts of the two cases. On June 27, 1944, since the filing of briefs in this proceeding, the Fifth Circuit affirmed us in the *Quintana Petroleum Company* case. See *Quintana Petroleum Company* v. *Commissioner*, — Fed. (2d) —. Therefore, upon the authority of *Quintana*

Petroleum Company v. *Commissioner*, we sustain the respondent's determination upon this issue and in accordance with the stipulation the petitioner is "entitled to an additional deduction for depletion in the fiscal year ended February 28, 1938 in the amount of $45,754.36". Cf *Estate of Dan A. Japhet*, 3 T. C. 86.

Issue No. 2. Petitioner contends that the additional corporation franchise taxes for the taxable years 1937 and 1938 asserted by the State in 1940 and paid by petitioner in 1940 actually "accrued" as a liability during the respective taxable years in question and that since petitioner kept its books on the accrual basis, the taxes so asserted and paid are deductible for the taxable years 1937 and 1938, respectively.

Section 23 (c) of the Revenue Act of 1936 provides that in computing net income there shall be allowed as deductions "Taxes paid or accrued within the taxable year" with certain exceptions none of which are material here. Section 48 (c) of the same Act provides that when used in this title "The terms 'paid or incurred' and 'paid or [fol. 70] accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part." Petitioner's method of accounting was the accrual method.

The respondent concedes that the rule is well established that taxes accrue when all events have occurred that fix the amount of the tax and determine the taxpayer's liability to pay it, citing *Oregon Pulp & Paper Co.*, 47 B. T. A. 772, 780, and the cases therein cited. The respondent contends, however, that petitioner has failed to show that all the events fixing the additional franchise tax liabilities here involved transpired during the years 1937 and 1938, and that, therefore, "there is no basis upon which this Court can permit the accrual and deduction of the taxes in the years 1937 and 1938". We think this contention by respondent cannot be sustained.

In *Oregon Pulp & Paper Co.*, *supra*, we held that the taxpayer there could not deduct in 1936, the year of payment, the amount of an additional excise tax demanded from the taxpayer by the State of Oregon for the year 1934. We said there that all events had transpired prior to 1936 which fixed the amount of the liability; that the taxpayer had erroneously computed the amount of its tax to the

state; and that the subsequent discovery of the error in 1936 "related back to the taxable year in which the mistake occurred". This is all the petitioner in the instant proceeding is claiming.

The liability for the franchise taxes in question was fixed by Louisiana state laws. These laws were in force during the taxable years 1937 and 1938. Petitioner had erroneously computed the amount of the liability. The subsequent discovery of the error and the correction thereof in 1940 related back to the taxable years 1937 and 1938 in which years the mistake occurred. *Oregon Pulp & Paper* [fol. 71] *Co., supra*, p. 780. We hold that the amounts of $814.11 and $1,237.83 are allowable deductions for the taxable years 1937 and 1938, respectively, under section 23 (c), *supra*.

Issue No. 3. The question involved in this issue is substantially the same as the one that was recently decided by the Supreme Court in *Dixie Pine Products Company* v. *Commissioner*, 320 U. S. 516. Both parties in their briefs seem to agree that the Supreme Court's decision in that case is controlling. In its brief petitioner concedes that "The income taxes therefore will be deducted under this decision of the Supreme Court when the litigation is finally adjudicated." We hold that the same rule applies also to the interest items in question. Section 23 (b) of the Revenue Act of 1936 provides for the allowance as deductions of "All interest paid or accrued within the taxable year on indebtedness * * *." Here the taxpayer is contending before the Board of Tax Appeals of the State of Louisiana that it is not indebted to the State for the amounts on which the interest is based. We hold that petitioner is not entitled to any deductions for the taxable years 1937 and 1938 on account of either the contested additional income taxes or the interest thereon, the amounts of which are set out in our findings of fact. *Dixie Pine Products Company* v. *Commissioner*, *supra*.

Issue No. 4. Section 23 (a) of the Revenue Act of 1936 as amended by section 121 of the Revenue Act of 1942 provides that in computing net income there shall be allowed as deductions "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." Petitioner contends that the

item of $27,564.61 here in question is deductible under this provision of the statute, and cities *Welch* v. *Helvering*, 290 U. S. 111, 12 AFTR 1456; *L. B. Reakirt*, 29 B. T. A. 1256, [fol. 72] affirmed *per curiam* 84 Fed. (2d) 996, 18 AFTR 277; *Commissioner* v. *Chicago Dock & Canal Co.*, 84 Fed. (2d) 288, 17 AFTR 1277; and *Commissioner* v. *Heininger*, 320 U. S. 467.

Section 24 (a)(2) of the Revenue Act of 1936 provides that in computing net income no deduction shall in any case be allowed in respect of "Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Pursuant to section 62 of the Revenue Act of 1936, the respondent prescribed and published as a needful regulation for the enforcement of section 24 (a)(2), Article 24-2, Regulations 94, which among other things provides that "The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense." In referring to an identical provision of Regulations 86, the Tenth Circuit in *Farmer, et al.* v. *Commissioner*, 126 Fed. (2d) 542, 28 AFTR 1378, affirming on this point *Central Material & Supply Co.*, 44 B. T. A. 282, said:

> This regulation finds general support in the decisions of the Courts. The authorities quite generally hold that expenditures made in defense of a title upon which depends the right to receive oil and gas royalty payments are capital expenditures and not deductible as ordinary business expenses. Croker v. Helvering, 67 App. D. C. 226, 91 F. 2d 299; Murphy Oil Co. v. Burnet, 9 Cir., 55 F. 2d 17, 26; Blackwell Oil & Gas Co. v. Commissioner, 10 Cir. 60 F. 2d 257. Petitioners did more than litigate the right to receive oil royalty payments. The title to the oil and gas lease under which they received these payments depended upon the title to the land. Without title to the land they had nothing. It was therefore necessary for them to defend and establish the title to the land in order to retain their interest in the oil and gas. The decision of the [fol. 73] Commissioner and of the Board in this respect is approved.

To the same effect is *Jones' Estate v. Commissioner*, 127 Fed. (2d) 231, 29 AFTR 226, and *Mosmer v. Welch*, 97 Fed. (2d) 471, 24 AFTR 532. We think it is true, as stated by the Court in *Farmer, et al. v. Commissioner, supra*, that "the authorities quite generally hold that expenditures made in defense of title upon which depends the right to receive oil and gas royalty payments are capital expenditures and not deductible as ordinary business expenses."

While the general rule is as above stated, the Board held in *L. B. Reakirt, supra*, that attorney fees paid by a taxpayer engaged in the real estate and investment business in resisting an illegal attempt by a city to condemn and acquire certain of his property are deductible as ordinary and necessary expenses of such business. Our decision in the *Reakirt* case was affirmed C. C. A., Sixth Circuit *per Curiam supra*. We do not believe that the *Reakirt* case has been overruled by the later decisions which we have cited above. There can be no doubt that suit at law No. 284 filed by the United States of America in the District Court of the United States for the Western District of Louisiana, described in our findings of fact, was a condemnation suit. If the United States had prevailed against petitioner, who became a party to that suit, all of petitioner's 19 producing oil wells would have been taken. Petitioner employed counsel and defended against the Government's effort to condemn its property upon the ground that its properties were not included in the proper boundaries of the lands which the Government was seeking to condemn. Petitioner prevailed in this contention and judgment was entered by the United States District Court in petitioner's [fol. 74] favor. While it is unquestionably true that the principal question involved in the condemnation suit in so far as the Government and petitioner were concerned was the correct location of boundary lines, it is also true that the suit was a condemnation suit and that as a result of the judgment petitioner's property upon which its 19 producing oil wells were located was not taken by the United States Government. We think the expenses aggregating $27,564.61, which petitioner expended to prevent its property being taken, should be allowed as ordinary and necessary business expenses incurred in resisting condemnation proceedings under authority of *L. B. Reakirt, supra*. The fact that the taxpayer in the *Reakirt* case was engaged in the real estate and investment business whereas the taxpayer

in the instant case is engaged in the production and sale of oil is, we think, without any important significance. The important factor in each case is that the expenditures in question were made in preventing the taxpayer's property from being taken in a condemnation proceeding. Article 24-2, Regulations 94 is not applicable to such a state of facts.

On Issue No. 4 petitioner is sustained.

Reviewed by the Court.

Decision will be entered under Rule 50.

DISSENTING OPINION

TURNER, J., dissenting:

Assuming the soundness of the conclusion reached in *L. B. Reakirt*, 29 B. T. A. 1296, which, in my opinion, is not free from doubt, I am still unable to agree with the majority that that case is decisive of the question in the fourth issue above. The question here is one of property boundary. If the boundary line was located as the petitioner contended, there was no question as to petitioner's title as lessee to the lands on which its oil wells were located, and the property was not within the claim of the Government. If on the other hand, the bound- [fol. 75] ary line was located as contended by the Federal Government, petitioner had no title as lessee or otherwise to the lands it had developed. It seems to me thus apparent that petitioner's expenditures were in defense of the title to its property and being such were capital expenditures, not deductible as ordinary and necessary expenses. *Central Material & Supply Co.*, 44 B. T. A. 282, affirmed 126 Fed. (2d) 542; and *Jones' Estate* v. *Commissioner*, 127 Fed. (2d) 231, affirming 43 B. T. A. 691. The fact that the question on title arose in a condemnation suit, is in my opinion, of no moment. I accordingly note my dissent.

Murdock, Mellott, Arnold, and Kern, JJ., agree with this dissent.

(Seal.)

IN THE TAX COURT OF THE UNITED STATES

Docket No. 110566

BURTON-SUTTON OIL COMPANY, INCORPORATED, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to the determination of the Court as set forth in its Findings of Fact and Opinion promulgated August 4, 1944, the respondent herein filed a proposed recomputation on September 4, 1944, which was not contested by petitioner when called for hearing September 27, 1944, now therefore, it is

Ordered and Decided: That there are deficiencies in income tax and excess profits taxes for the fiscal years ended [fol. 76] February 29, 1936, February 28, 1937 and February 28, 1938, in the following amounts:

	Income Tax	Excess-Profits Tax
1936	$10,799.01	$ 667.42
1937	66,108.95	27,802.18
1938	61,378.43	23,221.79

Enter: Entered Sep. 30, 1944.

(Signed) Eugene Black, Judge. (Seal.)

IN UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

PETITION OF BURTON-SUTTON OIL COMPANY, INCORPORATED, FOR REVIEW BY THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT OF A DECISION BY THE TAX COURT OF THE UNITED STATES—Filed December 11, 1944

To the Honorable Judges of the United States Circuit Court of Appeals for the Fifth Circuit:

Burton-Sutton Oil Company, Incorporated, your petitioner by its attorneys, Norman F. Anderson, Elias R.

Kaufman and W. W. Thompson, respectfully petitions this Honorable Court to review a decision of the Tax Court of the United States entered on September 30, 1944.

I. Jurisdiction

Your petitioner is a corporation duly organized and existing under the laws of the State of Louisiana, and has its [fol. 77] principal place of business at Lake Charles, Louisiana.

Your petitioner filed its income and excess-profits tax returns for the years in question, namely, the fiscal years ended February 29, 1936, February 28, 1937 and February 28, 1938, with the Collector of Internal Revenue at New Orleans, Louisiana, whose office is located within the jurisdiction of the United States Circuit Court of Appeals for the Fifth Circuit, where this review is sought:

The controversy comes up for review as follows: The respondent sent your petitioner a notice of deficiency on January 16, 1942, showing deficiencies in income and excess-profits tax liabilities for the said fiscal years. On April 14, 1942, your petitioner filed its petition in the Tax Court of the United States seeking a redetermination of its tax liabilities for each of the said years. The respondent filed an answer on May 29, 1942, praying that the appeal be denied. After hearing, the Tax Court promulgated its Findings of Fact and opinion August 4, 1944. Decision was rendered and entered September 30, 1944.

Jurisdiction in this Court to review the decision of the Tax Court of the United States is founded on sections 1141 and 1142 of the Internal Revenue Code.

II. Nature of Controversy

This case involves income and declared value excess-profits tax liabilities. The Tax Court entered its decision for deficiencies as follows:

Year Ended	Income Tax	Excess-Profits Tax
February 29, 1936	$10,799.01	$ 667.42
February 28, 1937	66,108.95	27,802.18
February 28, 1938	61,378.43	23,221.79

[fol. 78] These deficiencies grew out of adjustments made by the respondent to your petitioner's tax returns including the addition to taxable income of the following amounts:

Year Ended	Additions
February 29, 1936	$ 17,406.19
February 28, 1937	232,498.94
February 28, 1938	286,128.28

which represented payments made by your petitioner to the Gulf Refining Company.

The Gulf Refining Company held an original lease on certain potential mineral land. It entered into a contract with J. G. Sutton which permitted and required Sutton to explore the leased lands for oil and gas, and required that fifty (50) per cent of the net proceeds from oil and gas be paid to the Gulf Refining Company. The "net proceeds" were to be determined according to particular contract provisions. Petitioner acquired Sutton's rights. Petitioner's exploration proved the lease productive. The aforesaid payments were due Gulf Refining Company as its share of the net proceeds. In addition to the said payments, and among other things, the Gulf Refining Company retained out of the leasehold rights:

(1) An overriding royalty in favor of S. W. Sweeney.

(2) All sulphur rights.

(3) The right to purchase all oil produced.

(4) The right to terminate Sutton's rights in the lease at least thirty (30) days before the expiration of the original lease.

[fol. 79] All facts with respect to this issue were stipulated by the parties and were adopted by the Tax Court.

The respondent (Commissioner) contends that the payments represent a part of the cost of the lease to your petitioner and are, therefore not to be deducted or excluded from taxable income except as they are recovered through depletion. Your petitioner's position is that the payments represent ordinary income of the Gulf Refining Company from oil and gas wells and do not constitute gross income to your petitioner, or in the alternative, that the payments are allowable deductions as rentals, royalties, or other or-

"It is plain that respondent's legal expenses were oth 'ordinary and necessary' if those words be given eir commonly accepted meaning. For respondent to nploy a lawyer to defend his business from threatened estruction was 'normal'; it was the response ordiarily to be expected. Cf. Deputy v. du Pont, 308 U. S. 88, 495; Welch v. Helvering, 290 U. S. 111, 114; Kornauser v. United States, *supra*. Since the record contains no suggestion that the defense was in bad faith r that the attorney's fees were unreasonable, the exenses incurred in defending the business can also be ssumed appropriate and helpful, and therefore 'necesary.' Cf. Welch v. Helvering, *supra*, 113; Kornhauser . United States, *supra*, 152."

Trust u/w of Mary Lily (Flagler) Bingham v. Comoner of Internal Revenue, decided June 4, 1945, the 09} Supreme Court, in holding that attorney's fees by a trustee for legal services concerning "(1) litigain which the trustees unsuccessfully contested a dekey claim based on taxable gain to the estate, (2) payof a legacy, and (3) problems arising from the expiraof the trust and the disposition of its assets," were deble as a business expense, said:

"• • • Section 23(a)(2) does not restrict deductions to those litigation expenses which alone produce ncome. On the contrary, by its terms and in analogy with the rule under Sec. 23(a)(1), the business expense section, the trust, a taxable entity like a business, may leduct litigation expenses when they are directly conected with or proximately result from the enterprise—the management of property held for production of income. Kornhauser v. United States, *supra*, 152-153; Commissioner v. Heininger, *supra*, 470-471."

also *Welch v. Helvering*, 290 U. S. 111, 114; *A. Harris o. v. Lucas*, 48 F. 2d 187; *Bliss v. Commissioner of Inal Revenue*, 57 F. 2d 984; *Commissioner of Internal nue v. Chicago Dock & Canal Co.*, 84 F. 2d 288.

he Tax Court correctly decided that these expenditures an ordinary and necessary business expense and as were deductible in the tax year in which such payments made.

[fol. 100] JUDGMENT

Extract from the Minutes of July 6th, 1945

No. 11275

BURTON-SUTTON OIL COMPANY, Incorporated,

versus

COMMISSIONER OF INTERNAL REVENUE

This cause came on to be heard on the petition of Burton-Sutton Oil Company, Incorporated, for a review of a decision of The Tax Court of the United States, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

"LEE, Circuit Judge, concurs in the result."

[fol. 101] CLERK'S CERTIFICATE

UNITED STATES OF AMERICA:

UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

I, Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, do hereby certify that the pages numbered from 87 to 100 next preceding this certificate contain full, true and complete copies of all the pleadings, record entries and proceedings, including the opinion of the United States Circuit Court of Appeals for the Fifth Circuit, in a certain cause in said Court, numbered 11275, wherein Burton-Sutton Oil Company, Incorporated, is petitioner, and Commissioner of Internal Revenue is respondent, as full, true and complete as the originals of the same now remain in my office.

I further certify that the pages of the printed record numbered from 1 to 86 are identical with the printed record upon which said cause was heard and decided in the said Circuit Court of Appeals.

In testimony whereof, I hereunto subscribe my name and affix the seal of the said United States Circuit Court of Appeals, at my office in the City of New Orleans, Louisiana, in the Fifth Circuit, this 13th day of July, A. D. 1945.

Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals, Fifth Circuit.

(9593)

[fol. 102] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed February 11, 1946

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Jackson took no part in the consideration or decision of this application.

Endorsed on Cover: File No. 50,064. U. S. Circuit Court of Appeals, Fifth Circuit. Term No. 361. Burton-Sutton Oil Company, Incorporated, Petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed August 23, 1945. Term No. 361 O. T. 1945.

FILE COPY

No. 361

OFFICE - Supreme Court, U. S.
FILED
AUG 23 1945
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

October Term, 1945.

BURTON-SUTTON OIL COMPANY, INCORPORATED, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND SUPPORTING BRIEF.

CULLEN R. LISKOW,
Attorney for Petitioner.

NORMAN F. ANDERSON,
W. W. THOMPSON,
ELIAS R. KAUFMAN,
Of Counsel for Petitioner.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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No. ——

IN THE

Supreme Court of the United States

October Term, 1945.

BURTON-SUTTON OIL COMPANY, INCORPORATED, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

MAY IT PLEASE THE COURT:

Petitioner, Burton-Sutton Oil Company, Incorporated, respectfully prays for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit at New Orleans, Louisiana, to hear this cause and to review the decision of the Circuit Court of Appeals in affirming the judgment of the Tax Court of the United States. Petitioner respectfully shows to this Honorable Court:

SUMMARY STATEMENT OF THE MATTER INVOLVED.

This case involves income and excess profits taxes for fiscal years ended in 1936, 1937 and 1938. It was tried before the Tax Court on the pleadings (R. 3-36) and stipulations of fact (R. 45-54).

The Gulf Refining Company, hereinafter referred to as "Gulf," held an original lease on certain potential mineral land. On February 18, 1933, Gulf transferred a part of certain oil and gas rights granted in the original mineral lease to one J. G. Sutton (R. 46-51). Gulf was to receive 50% of the net profits (R. 47), but was not to be responsible for losses and expenses (R. 49). In addition to the share of net profits, Gulf retained:

(a) A part of its estate:
  (1) An overriding oil royalty for the benefit of a third party (R. 47)
  (2) All sulphur rights (R. 50)

(b) A part of its term: The right to terminate Sutton's use of the oil and gas rights at least thirty days prior to any obligation occuring under the original lease (R. 46)

(c) An advantage: The right to purchase all oil produced "during the life of this agreement" (R. 50, 51)

Petitioner acquired the contract from Sutton on February 27, 1933 (R. 45) and shortly thereafter proceeded to the development and operation of the property and obtained oil in paying quantities (R. 51). In accordance with the provisions of the contract, petitioner paid Gulf the following sums during the taxable years indicated (R. 51):

1936	$ 17,406.19
1937	232,498.94
1938	286,128.28

The foregoing amounts were claimed as deductions in the returns filed for the respective years and were disallowed by the Commissioner on the ground that they represented cost of the property recoverable through depletion allowances (R. 51). Depending upon the final decision, the depletion allowable will be determined under Rule 50 of the Tax Court (R. 52).

Petitioner's appeal to the Tax Court was prosecuted on the grounds (a) that the Gulf payments did not constitute income to it, or (b) were deductible as ordinary and necessary expenses.

The Tax Court sustained the Commissioner (R. 69). The Circuit Court of Appeals affirmed the decision on the grounds (a) that the agreement to pay a percentage of net profits does not grant an economic interest in the oil in place and were not made with respect to royalty interests retained by Gulf but were paid as consideration for the execution of the conveyance, and (b) that since control of operations was in the taxpayer and operating losses were to be borne by it, that the taxpayer and Gulf were not partners or joint adventurers (R. 88).

STATEMENT DISCLOSING BASIS UPON WHICH IT IS CONTENDED THIS COURT HAS JURISDICTION.

The jurisdiction of this cause is conferred upon this Honorable Court by Judicial Code, Section 240, as amended; United States Code, Title 28, Sections 347.

The judgment of the Circuit Court of Appeals was entered July 6, 1945 (R. 97).

QUESTIONS PRESENTED

(a) Was the petitioner taxable on the Gulf Refining Company's share of the net profits (1) Did Gulf have an economic interest in the oil, or (2) did Gulf receive it as a co-partner?

(b) If the Gulf Refining Company's share represented gross income to your petitioner, was your petitioner entitled to deduct such payments therefor as ordinary and necessary business expenses?

4.

REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT.

The reasons relied on for the allowance of the writ are that the Circuit Court of Appeals has decided important questions which have not been and should be settled by this Court; that these questions have been decided in a way probably in conflict with the applicable decisions of this Court and that they have been decided in a way directly in conflict with decisions of the Ninth and Tenth Circuit Courts of Appeals.

(a) The basic issue here is the same as in *Kirby Petroleum Company* v. *Commissioner*, Docket No. 1139 of this Court, to be heard on a writ of certiorari granted May 28, 1945, upon the taxpayer's application. The writ in that case was apparently granted in order to resolve the direct conflict in that decision of the Fifth Circuit Court of Appeals with the decisions of the Ninth Circuit Court of Appeals in *Commissioner* v. *Fehr Oil Company*, 144 F. 2d 27, and *Commissioner* v. *Anna Dickson Crawford*, decided April 21, 1945, 148 F. 2d 777, all of which involved depletion allowances on oil net profits payments.

Appeals in said cause entitled Burgess Storage Co. [illegible]
[illegible] Petitioner, vs. Commissioner of [illegible]
Respondent, No. 11275 on its docket, [illegible]
and that the said cause may be reviewed and determined
by this Court as provided by Section 240 of the Judicial
Code, as amended, and that your petitioner may have such
other and further relief or remedy in the premises as this
Court may deem appropriate and in conformity with the
provisions of the Judicial Code, and that on hearing hereof
this Honorable Court said judgment of the Circuit Court
of Appeals be reversed.

BURGESS STORAGE CO.,
INCORPORATED,
By CLIFTON R. LASKEY,
Attorney for Petitioner.

NORMAN F. ANDERSON,
W. W. THOMPSON,
CLIFTON R. LASKEY,
of Counsel for Petitioner.

IN THE

Supreme Court of the United States

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court is found at page 54 of the record and is reported in 3 T. C. 1187. The opinion of the Circuit Court of Appeals has not been reported but is found at page 87 of the record.

II.

JURISDICTION.

Stated under heading 2 of the petition.

III.

STATEMENT OF THE CASE.

A full statement of the case has been given under heading 3 of the petition and in the interest of brevity is not repeated.

IV.

THE LAW.

REVENUE ACT OF 1934:

"Sec. 22. Gross Income.

"(a) General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

* * * * * * * * *

(26 U. S. C. A. 669, 1940 Ed.)

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

(26 U. S. C. A. 671, 1940 Ed.)

"Sec. 181. Partnership not Taxable.

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

(26 U. S. C. A. 738, 1940 Ed.)

"Sec. 182. Taxes of Partners.

"There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year."
(26 U. S. C. A. 728, 1940 Ed.)

"Sec. 801. Definitions.

"(a) When used in this act—

* * * * * * *

"(3) The term 'partnership' includes a syndicate, group, pool, joint venture, or other incorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this act, a trust or estate or a corporation, and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization."
(26 U. S. C. A. 790, 1940 Ed.)

"Sec. 24. Items Not Deductible.

"(a) General Rule.—In computing net income no deduction shall in any case be allowed in respect of * * *"

* * * * * * *

"(2) Any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate."
26 U. S. C. A. 675, 1940 Ed.)

REVENUE ACT OF 1936:

The applicable provisions of the Revenue Act of 1936 are identical with the foregoing.

V.

SPECIFICATION OF ERRORS.

1. The Circuit Court of Appeals erred in holding that the Gulf Refining Company's shares of net income constitute gross income to petitioner.

2. The Circuit Court of Appeals erred in holding that petitioner's payments of the Gulf Refining Company's shares are capital expenditures.

3. In the alternative, if the payments to the Gulf Refining Company are income to your petitioner, the Circuit Court of Appeals erred in failing to hold that the said payments are deductible as ordinary and necessary business expenses.

SUMMARY OF THE ARGUMENT.

Point A.

The Gulf Refining Company has an economic interest in the oil and its 50% share of the net proceeds from production is not gross income to your petitioner.

Point B.

Moreover, the Gulf contract is one of partnership or joint adventureship and your petitioner is not taxable on the distributive share of its co-partner.

Point C.

In the alternative, the payments are required to be made as a condition to the continued use and possession of the property and are ordinary and necessary business expenses.

ARGUMENT.

Point A.

The Gulf at all times had an economic interest in the oil. This interest is as great, or even greater than that of your petitioner, and your petitioner should not be taxed upon the income derived from that interest.

While depletion is not at issue here, the controlling principal is the same. This Court said in *Anderson* v. *Helvering*, 310 U. S. 404, 407:

> "It is settled that the same basic issue determines both to whom income derived from the production of

oil and gas is taxable and to whom a deduction for depletion is allowable."

The decision of the Fifth Circuit is, therefore, directly in conflict on this basic issue with the *Felix*[1] case of the Ninth Circuit where it was held that a landowner was entitled to a depletion allowance upon his only income from the wells, a 50% net profits payment. The recent decision of the Ninth Circuit in the *Crawford*[2] case was to the same effect.

The conflict between the Circuits on this fundamental issue is also seen in *Commissioner* v. *Kirby Petroleum Co.*[3] in which the Fifth Circuit decided the precise question involved in the *Felix* case contrary to the rule followed by the Ninth Circuit. This, obviously, was the primary reason for this Court granting the taxpayer's application for a writ of certiorari in the *Kirby* case.

In view of the foregoing, it is respectfully urged that, if for no other reason, your petitioner's application should be granted in order that it may be decided by this Honorable Court with and according to the same fundamental principles in respect to economic interests as may be found applicable in the *Kirby* case.

The decision here is also directly in conflict on the exact question involved with the Ninth Circuit's decision in *Holly Development Co.* v. *Commissioner*, 93 F. 2d 146. The facts there were that Argonaut had transferred leases to one Sinsheimer who was to pay operating expenses, make certain other payments and thereafter "all of the remainder of the proceeds, less cost of additional development, to be distributed 60% to Sinsheimer and 40% to Argonaut, inclusive of the monthly payment of $6,000.00 unless the drilling expenses exceeded the amount of $120,000.00, in which event the remainder was to be distributed 65% to Sinshei-

---

1 *Commissioner* v. *Felix Oil Company*, 144 F. 2d 276.

2 *Commissioner* v. *Anna Vickers Crawford*, 148 F. 2d 777, decided April 21, 1945.

3 Decided March 5, 1945. 148 F. 2d 80; Docket No. 1139 of Supreme Court; certiorari granted May 21, 1945.

mer and 35% to Argonaut." The Holly Development Company acquired Sinsheimer's contract and made the payments as provided, including the percentages of net proceeds to Argonaut. The Commissioner contended there, as here, that the payments were capital expenditures made in connection with the acquisition of capital assets and were in reality a part of the purchase price and, therefore, includible in the gross income of petitioner. After thus stating these contentions, the Court said:[4]

> "We are unable to accept this view of respondent because, by the agreement referred to, Argonaut excepted and reserved to itself an interest in the lease and the oil."

The Fifth Circuit, in rejecting your petitioner's contention that Gulf had an economic interest, cited its own decision in *Quintana Petroleum Company* v. *Commissioner*, 143 F. 2d 588 (no application for certiorari), the *Kyle* case referred to above, and the so-called net profits cases of this Court, *Helvering* v. *O'Donnell*, 303 U. S. 370, and *Helvering* v. *Elba Oil Land Company*, 303 U. S. 372.

The taxpayer in the *O'Donnell* case at no time owned any interest in the oil and gas. He merely owned a part of the stock in a corporation which had oil properties and he exchanged his shares in a deal with the third person who agreed to acquire the corporation's oil properties and to pay O'Donnell, the stockholder, an amount equivalent to one-third (1/3) of the net profits from the oil operations. That is substantially different from the present case. Here, Gulf owned the entire working interest and agreed to share that interest with the petitioner upon the petitioner assuming the management and certain financial risks.

[4] Lest it be argued that this case was in effect overruled by or is out of harmony with *Commissioner* v. *Elbe Oil Land Development Co.*, 303 U. S. 372, it should be noted that Circuit Judge Garrecht, the organ of the Court in the *Holly* case, entered his dissent in the *Elbe* case (91 F. 2d 127, 130) expressing the view that Elbe was not entitled to a depletion allowance.

In the *Elbe* case, the taxpayer had owned the working interest but it made an absolute sale for $2,000,000.00 plus the agreement of the purchaser to pay additional money in the amount of one third (⅓) of the net profits if, after the purchaser had reimbursed itself for the cost of acquisition and all subsequent development and operating costs and expenses, there were any profits. As this Court pointed out (page 374), the agreement there specifically provided:

> "It is the intention of the parties to this agreement that the full ownership, possession and control of all the properties . . . shall be vested in Honolulu (purchaser) and Elbe shall have no interest in or to the said properties."

Accordingly, this Court held that after the execution of such a contract, the taxpayer had no further interest in the properties and was not entitled to an allowance for depletion upon the $2,000,000.00 on the theory that it represented capital.

Technically, in the present case, there was no sale. Gulf assigned only a part of its "estate" and only a part of its "term." Therefore, the agreement here to pay a share of the net profits is no mere personal covenant but it is a covenant running with the property.

Moreover, disregarding refinements of title, the art of the conveyancer and looking at the transaction broadly and to its practical aspects, it is clear that Gulf has an economic interest in the oil and gas. The Gulf Refining Company owned the entire working interest, and before the Sutton contract it admittedly had an investment in the oil and gas in place. Under the contract here, Gulf was given no money or other source to which it could look for the recovery of its

[1] Gulf specifically retained (a) an overriding royalty for the benefit of a third party (R. 47), (b) all sulphur rights (R. 50), and (c) the right to purchase all oil produced "during the life of this agreement" (R. 50).

[2] Gulf had the reversion of the oil rights under a covenant for reassignment by Sutton before the maturity of any obligation under the lease (R. 46).

investment except the production of oil and gas. The instant production was obtained, Gulf's capital investment commenced to diminish and thereafter it has shrunk as each unit is severed. Gulf's investment will be exhausted only when production cannot be had in paying quantities. On the other hand, petitioner does not enjoy Gulf's share of the net income. It derives no more benefit from Gulf's share than do the operators who share with the landowners in the *Kirby*, *Felix* and *Clanton* cases. Considering that such expenses are not taken into account in computing Gulf's share of the profits and that Gulf has its reversion of the oil rights, it is believed that Gulf's interests are actually greater than your petitioner's.

Point B.

In the event it is decided that Gulf has no economic interest in the oil, still your petitioner is not taxable on Gulf's share because, under the contract, the parties were limited partners. This was argued below but was rejected, the Court stating (R. 88):

> "It is argued that the taxpayer and its transferor were joint adventurers in the enterprise. Since complete control of all operations of the properties was in the taxpayer, and under the agreement all expenses and losses were to be borne by it, we deem this contention to be untenable."

Generally, as well as under local law of Louisiana, a special partner is prohibited from taking any active part in the business, under penalty of liability as a general partner, and the proportion of losses and expenses is regulated as

> "Ordinarily, special partners are denied the right to participate in the management of the firm business * * * under penalty of being liable as a general partner." 40 Amer Jur, page 479.
>
> "* * * And if any partner in commendam shall take any part in the business * * * such partner shall be liable to all the responsibilities of a general partner." *Louisiana Revised Civil Code* Article 2849

between themselves, by their agreement.[8] A limited partnership is recognized as taxable as an ordinary partnership, if not taxable as an Association, by the Commissioner's present Regulations.[9]

The Tenth Circuit Court of Appeals in *Reynolds v. McMurray*, 60 F. 2d 843, (certiorari denied) held that a joint venture existed notwithstanding that one party had no control over operations and had no personal liability for losses and expenses. The facts there were that one Armstrong and the Ohio Oil Company owned oil leases in the proportions of 40% and 60%, respectively, and on December 7, 1917, entered into an agreement which provided that the Ohio Oil Company should manage, control and develop the lease and should immediately drill a well thereon at its own expense. After completion of the well, the Ohio Company should continue to manage and operate the properties and should market the oil and account to Armstrong for his proportionate part thereof and should make monthly remittances to him after deducting the amounts due to it for expenditures made by it for him. Armstrong later assigned a part of this interest to William McMurray, the taxpayer, and thereafter the Ohio Company carried an account in the name of McMurray, crediting his account with the oil runs and charging him with disbursements and operations of the lease. The Ohio Company was obligated to make the disbursements to carry the Armstrong interest without any personal obligation on the part of Armstrong to make reimbursements. In substance, therefore, the contract was to receive a percentage of the net proceeds. The Commissioner was maintained in taxing McMurray with

[8] The proportion of profits to be received by the partner in commendam may be regulated by the covenant of the parties, as may also, with respect to each other, the proportion of losses and expenses to be borne by each of the partners. * * *" *Louisiana Revised Civil Code*, 1870, 2841. See also *I. T.* 2848, C. B. 1923-1, p. 6, where it was said "A sharing of losses is not, according to the best authorities, indispensable to a partnership" and S. T. 1261, C. B. 1920-1 p. 11, where an agreement was held to be a partnership although net losses were borne by an individual partner alone.

[9] Sec. 111, Sec. 29.3797-1.

the full amount of the gross proceeds applicable to his proportionate interest less deductions for expenses applicable to his interest upon the theory of a joint venture and before joint ventures were first included in the definition of a "partnership" under the Revenue Act of 1932. The Ninth Circuit followed in *Helvering* v. *Armstrong*, 69 F. 2d 370.

Even in the absence of the conflict created by the *Morgan* and *Armstrong* cases, there is an important question of Federal law involved in whether active participation in management and sharing of losses are essential to the establishment of a partnership for income tax purposes. That question has not and should be settled by this Honorable Court.

Point C.

In the event the Gulf's share of the net income is taxable as petitioner's income, the payments are ordinary and necessary business expense of your petitioner. It has been pointed out above that Gulf's assignment to Sutton was of a lesser interest than the whole of its estate and for a period less than its term. Accordingly, each payment made by Gulf is required as a condition to the continued use of the property and is deductible under the express provisions of Section 23(a) of the Revenue Acts of 1936 and 1938, supra. The deduction of these payments by the payor is consistent with the Commissioner's position in the *Kirby Petroleum* and *Crichfield* cases, supra, where he has sought to tax the person receiving such payments with the amounts as ordinary income (without allowance for depletion) and not as proceeds arising from the sale of property. It presents a question which has not and should be settled by this Honorable Court.

CONCLUSION.

It is respectfully submitted that this case is such as to call for the exercise by this Court of its supervisory powers, and We, therefore, respectfully pray that the petition for writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit be granted.

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Attorney for Petitioner.

NORMAN E. ANDERSON,
W. W. THOMPSON,
ELIAS R. KAUFMAN,
Of Counsel for Petitioner.

FILE COPY

Supreme Court of the United States

OCTOBER TERM, 1945.

FILED
MAR 18 1946
CHARLES ELMORE CROPLEY

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED,
Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

BRIEF FOR THE PETITIONER.

CULLEN R. LISKOW,
NORMAN F. ANDERSON,
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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1945.

No. 361.

BURTON-SUTTON OIL COMPANY, INCORPORATED,
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versus

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

BRIEF FOR THE PETITIONER.

OPINIONS BELOW.

The opinion of the Tax Court (R. 42-54) is reported at 3 T. C. 1187. The opinion of the Circuit Court of Appeals (R. 66, 67) is reported at 150 F. 2d 621.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on July 6, 1945 (R. 76). The petition for a writ of certiorari was filed on August 23, 1945 and was granted on February 11, 1946 (R. 78). The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED.

The question is whether the Tax Court and the Circuit Court of Appeals erred in holding that the taxpayer could not exclude or otherwise deduct from its taxable income payments made to its transferor's assignor, such payments being a share of the net income derived from the extraction and sale of oil.

STATUTE INVOLVED.

The relevant provisions of the statute involved are set forth in the Appendix, *infra*, p. 28.

STATEMENT.

This case involves income and excess profits taxes for fiscal years ended in 1936, 1937 and 1938. The facts on the issue before the Court were stipulated by the parties

(R. 34-39, 41) and were found by the Tax Court as stipulated (R. 44-47, 51).

On or about February 27, 1933, taxpayer acquired from J. G. Sutton a contract which had been entered into between the Gulf Refining Company of Louisiana and J. G. Sutton on February 18, 1933 (R. 35). The contract recited:

> "That, Gulf Refining Company of Louisiana, hereinafter styled 'Grantor', for and in consideration of Ten Dollars ($10.00) and other valuable considerations to it in hand paid by J. G. Sutton, receipt of which is hereby acknowledged, has sold, conveyed and transferred, and does, hereby sell, convey and transfer unto the said J. G. Sutton, hereinafter styled 'Grantee', all oil and gas rights, titles, interests or privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.
>
> "This assignment is made subject to the following terms and conditions:
>
> "1. Grantee binds and obligates himself to begin on or before thirty days from date, operations for the drilling of a well on said land and to continue his operations thereon with reasonable diligence to completion or abandonment in an honest, bona fide effort to find oil or gas in paying quantities on said land. After the completion of said well, Grantee shall continue such operations on said land as may be necessary to continue said lease in full force and effect. If, after completing said well, Grantee shall desire to

cease operations on said land, he shall, upon demand reassign said lease to Grantor not less than thirty days prior to the maturity date of any obligation accruing after the date of the cessation of his operations of said land. (R. 35, 36.)

* * * * *

"After Grantee has met the underlying and overriding royalty obligations referred to in paragraph hereof and has been reimbursed out of the proceeds of the oil and gas produced from all such costs and expenses of operating upon said property as defined below, Grantee shall account to and pay Grantor 50% of the remaining portion of said proceeds of the oil and/or gas produced and sold from the said land * * *" (R. 36.)

The contract further stipulates how "accounting and settlement under this agreement shall be made" monthly (R. 36); for "the cost and expenses allowed in this agreement" (R. 37, 38); for keeping accurate records accessible for inspection and furnishing statements (R. 38); for Gulf's entry upon the land to produce sulphur (R. 38); and for an option in Gulf to purchase all oil "during the life of this agreement" (R. 39).

Shortly after acquisition taxpayer, pursuant to terms of the above contract, proceeded to the development and operation of the property and obtained oil and gas in paying quantities. In accordance with the provisions of paragraph 3 of the contract, the following sums were paid to the Gulf Refining Company of Louisiana during the taxable years indicated:

1936	$ 17,406.19
1937	232,498.94
1938	286,128.28

The foregoing amounts were claimed as deductions in the returns filed for the respective years. Respondent in his notice of deficiency has disallowed said deduction on the ground that the amounts paid to Gulf Refining Company represent additional cost of the property covered by the contract, recoverable through depletion allowances. Depending upon the Board's final decision the allowable depletion will be determined under Rule 50. (R. 50.)

The Tax Court sustained the Commissioner (R. 54) and the Circuit Court of Appeals affirmed. (R. 67.)

SUMMARY OF ARGUMENT

Through the provision for net profit payments the assignor retained an economic interest in the property and its share of the net profits was its own gross income from the property rather than the proceeds from the sale of a capital asset. Accordingly, the petitioner is not entitled to a statutory allowance for depletion with respect to the assignor's share of the income from the property nor is such share taxable as gross income of the petitioner.

ARGUMENT

The taxpayer petitioner in this case is required to pay underlying and overriding oil royalties to the lessor and lessee of the original lease and also 50% of the net income derived from oil production to its transferor, assignor

Gulf Refining Company, hereinafter called Gulf. The question involved is whether the taxpayer is entitled to exclude Gulf's share of the profits from its taxable income as not being gross income of the taxpayer under Section 22(a) of the Revenue Acts of 1934 and 1936, or otherwise deduct these profit payments as rentals paid under Section 23(a) of the Revenue Acts of 1934 and 1936. There is no dispute concerning the taxpayer's right to exclude the gross royalties from its taxable income. The only issue is whether the taxpayer is also entitled to exclude or deduct the payments made to Gulf under Gulf's stipulation for one-half of all of the net profits derived from the oil production.

Prior to the execution of the instrument involved here Gulf owned the entire capital investment in the oil in place with the exception of the lessor's underlying royalty and an outstanding overriding royalty; it alone, as the owner of the original lease, had the exclusive privilege of exploring the land and extracting all underlying minerals. Gulf granted this exclusive privilege in respect of the oil and gas only to the taxpayer's transferor on conditions which included the assumption of definite drilling and development obligations on the part of the assignee and the stipulation that it (Gulf) should receive 50% of all of the net income derived from the extraction of the oil in place.

The Tax Court and the court below held that the taxpayer could not deduct or exclude from its taxable income the net profit payments made by it to Gulf. The decisions below, of necessity, also determine that Gulf had made

an absolute sale of the property and that it does not receive gross income from the property, from which it also follows that Gulf may not deduct the allowance for depletion with respect to the net profit payments received from the taxpayer.

It is taxpayer's position that under Section 114(b)(3), construed in conjunction with Section 23(m) which provides for an allowance for depletion according to the peculiar conditions of each case and for an equitable apportionment between the lessor and lessee, and under the decisions of this Court that Gulf has gross income from the property by the reason of its provision for net profit payments upon which it alone is entitled to the allowance for depletion; that accordingly, Gulf's portion of the gross income from the property is not a part of the taxpayer's gross income as defined in Section 22(a), or such payments are otherwise deductible from gross income as rentals paid for the privilege of extraction under Section 23(a).

Where a taxpayer has a capital investment in only a portion of the mineral deposits, he is not entitled to depletion beyond the extent of interest; he may claim only the allowance with respect to "the gross income from the property" which he has "the right to retain". *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 321. Likewise, only the income upon which he may claim the allowance for depletion is included in his taxable gross income. *Thomas v. Perkins*, 301 U. S. 655, 663. Thus, the same basic considerations which establish who is entitled to depletion likewise determine to whom the gross income

from the property is taxable. "That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest." *Anderson v. Helvering*, 310 U. S. 404, 407.

In ascertaining who has a capital investment and the extent thereof, technical title to the oil in place is not important. *Burnet v. Harmel*, 287 U. S. 103; *Palmer v. Bender*, 287 U. S. 551; *Kirby Petroleum Company v. Commissioner*,[1] No. 56, this Term, decided January 28, 1946, 90 Law ed. Adv. Ops. 293; also see *Lynch v. Allworth-Stephens*, 267 U. S. 364. Nor is an interest to be determined from the form of the particular instrument involved or from the formalities of the kind of conveyance made; instead, it is the "practical consequences of the provision for payments" which are decisive. *Anderson v. Helvering*, 310 U. S. 404, 411. Thus, in *Thomas v. Perkins*, 301 U. S. 655, 659, where the granting clause in the assignment would have been sufficient, if standing alone, to transfer all of the oil to the assignee, the instrument was found to be qualified by other parts which unmistakably showed an intention to withhold from the operation of the grant an interest in the oil for the assignor. And earlier, in *Palmer v. Bender*, 287 U. S. 551, where the instrument was in the form of a sale reciting that the partnership "does sell, assign, set over, and transfer . . . unto the Ohio Oil Company", it was stated:

> "It will be observed that the statute directs that reasonable allowance for depletion be made as a deduction in computing net taxable income, 'in the case of oil and gas wells, . . . according to the peculiar

[1] The page references hereinafter made to the *Kirby* case are those of 90 Law ed. Adv. Ops.

conditions in each case . . . The allowance to the taxpayer is not restricted by the words of the statute to cases of any particular class or to any special form of legal interest in the oil well . . . . The concluding sentence of the section that 'In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and the lessee' presupposes that the deductions may be allowed in other cases. The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. (pp. 556-557.)

". . . whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil in place, identical with that of a lessor." (p. 558.)

Accordingly, the technical title to the oil in place, the form of the contract, and the legal relationship of the parties are all quite immaterial: it is enough for a taxpayer to have an "economic interest" and "By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment, which is necessarily reduced as the oil is extracted" and ". . . does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil" *Kirby Petroleum Company v. Commissioner, supra*, (p. 296).

The *Kirby* decision made a concrete application of these principles to provisions for net profit payments received by lessors and, in holding that such payments were subject to depletion, stated:

> "If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. *The lessors' economic interest in the oil is no less when their right is to share a net profit.* As in *Thomas v. Perkins*, 301 U. S. 655, *their only source of payment is from the net profit which the oil produces. In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply.* (p. 296.) (Italics suppied.)
>
> "*If* we assume that *the only payment* for the privilege of oil extraction *made* to the taxpayer lessors by the lessees *was the portion of 'net income'* paid under the leases, *it would be clear that such payment* of 'net income' *would taxwise be rent or royalty* paid by the lessees for the privilege of extraction. Since *Section 114(b)(3) would require the lessees to deduct this rent* or royalty from their gross incomes from the sale of oil from the property *before taking the lessees' depletion*, a gross receipt from oil sold, equal to the amount of the 'net income' paid to the taxpayer lessors, would not be subject to depletion, unless the taxpayer lessors are permitted to apply depletion to this payment. This would be contrary to the purpose of the depletion statute, which is to allow to the lessor and lessee together a depletion of 27½ per cent of the gross sale price of the oil. On the other hand, if depletion on the 'net income' pay-

ments is allowed to the lessors, the lessees are allowed depletion on the gross income from oil sales less the net income payment and the entire allowable depletion is allocated between the lessors and lessees." (p. 297.) (Italics supplied.)

The decision of necessity also determined that the lessees who made the profit payments were not required to include the portion of profits paid in their taxable income. (See *supra*, p. 7.)

A necessary corollary to the principle of economic interest is the rule that the statutory words "gross income from the property" governing the allowance for depletion, means gross income received from the operation of oil and gas wells by one who has a capital investment therein—not income from the sale of the oil and gas properties themselves. *Anderson v. Helvering*, 310 U. S. 404, 408, 410. "By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance." *Anderson v. Helvering, supra* (p 408). Thus, where there is a cash payment which does not depend upon production it is necessary to determine whether the transaction is essentially a lease or a sale in order to give character to such cash as ordinary income or as proceeds from the sale of a capital asset. (See also *infra* pages 18-20.) The instant case does not involve a cash payment which is made without regard to the extraction and sale of the oil in place or whether Gulf would have been entitled to depletion upon such a cash payment if it had

received such a payment; the only issue is concerned with whether Gulf receives gross income from the property by reason of payments which do depend solely upon the extraction and sale of the oil in place. It is our opinion that the possession of the right to receive payments which depend solely upon the production and sale of the oil in place to which Gulf must look for the return of its capital investment is of and in itself an economic interest; that, accordingly, there is no need to look to the instrument to determine whether it is a lease or a sale. Nevertheless, it can be readily seen that, if Gulf had received a cash bonus for the execution of the instrument here involved, such a cash payment would have been ordinary income; the deal was essentially a sublease and not a sale.

"If it is found that some of the principal relations, such as the duty to pay royalties, the duty to drill wells and develop and operate the premises, which make up the legal interest of the lessee of a lease for oil and gas purposes, have been expressly created, it is safe to assume that the intention was to create a leasehold interest, and not a separate estate in fee." Summers Oil and Gas, Permanent Edition, Vol. 1, p. 320, par. 132. The most essential difference between a lease and an absolute sale "is the fact that the predominating purpose of a lease is to secure the exploitation and development of the property". *Danciger Oil and Refining Company v. Powell*, 154 S. W. (2d) 632, 137 A. L. R. 408, 413; cited with approval in Westley W. West 3, T. C. 431, 453, affirmed in 150 F. 2d 723. To recover his capital investment, the lessor expects this development to yield payments which "do not normally become payable as the result of a single trans-

action within the taxable year, as in the case of a sale of the property". *Burnet v. Harmel*, 287 U. S. 103, 106; *infra*, p. 25. Since the lessee merely shares the profit derived from the land, he does not buy an interest from the lessor; "Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property". *G. C. M. 22739, C. B. 1941-1*, pp. 214, 217. Cf. *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372, *infra*, pp. 16-21.

The instrument involved in the instant case carries the provision for Gulf to receive payments out of production, which is a lessor's ultimate object in making a lease; it imposes a definite obligation to drill and develop and operate the leasehold premises which are the principal duties of a lessee. It is enough that Gulf has a right to payments identical with those of a lessor. *Palmer v. Bender, supra.* The Gulf contract, however, goes even further than *Palmer v. Bender* in that it imposes definite and affirmative duties upon the assignee which are identical with those of a lessee. It follows that Gulf did not sell the whole or any part of the interest in the original lease; instead, the taxpayer acquired an interest in the underlying minerals by assuming the obligations to drill an exploratory well and to further develop the property.

The reasoning of the *Kirby* decision and the conclusions reached there (p. 296) are particularly applicable here. If Gulf had stipulated for an overriding royalty out of gross production (or for an oil payment) instead of a portion of the net profits, there would have been no doubt as to its economic interest in such oil.[2] Its economic

[2] *Palmer v. Bender*, 287 U. S. 551 (overriding royalty); see *supra*, p. 8; *Thomas v. Perkins*, 301 U. S. 655 (oil payment).

interest is no less when its right is to share a net profit. Its only source of payment is from the net profit which the oil produces. In both situations, Gulf's possibility of return depends upon oil extraction and ends with the exhaustion of the supply.

Accordingly, whether Gulf became a technical sublessor or not, it retained, by its stipulation for net profit payments, an economic interest identical with that of a lessor.[3] It follows that Gulf did not sever its connection with the underlying oil and the income therefrom, but retained a continuing interest therein; the funds received by it do not constitute proceeds from the sale of a capital asset, but are Gulf's ordinary gross income from the property.[4] These payments, therefore, are to be excluded or are to be otherwise deducted from the taxpayer's gross income as rent or royalty paid for the privilege of extraction.[6]

The Commissioner, in determining that the taxpayer could not exclude the profit payments, was merely following the opinion consistently applied by his office since *G. C. M. 22730*, 1941-1 C. B. 214, 222, which is to the effect that the right to share the net profits derived from the operation of oil wells does not, in any event, represent a depletable economic right. Likewise, the Fifth Circuit Court of Appeals, in affirming the decision of the Tax Court, was following the same rule consistently used by

[3] *Palmer v. Bender*, 287 U. S. 551; 558, *supra* pp. 8 and 9.
[4] *Cf. Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372; *infra*, pp. 16-21. Also see *West v. Commissioner*, 150 F. 2d 723.
[5] *Anderson v. Helvering*, 310 U. S. 404, 410; *Thomas v. Perkins*, 301 U. S. 655, 663, *supra*, p. 8.
[6] *Kirby Petroleum Company v. Commissioner*, *supra*, p. 10.

that Court in all cases involving such rights.[6a] On the other hand, the Ninth Circuit Court of Appeals has always held that net profit payments do represent a depletable interest.[6b] The Tax Court, however, has put the cases on one side or the other depending upon whether the recipient also possesses either technical title, an additional payment payable out of gross production, or the surface of the land. The Tax Court's adverse decision in the instant case (R. . . . . ; 3 T. C. 1187) was put squarely upon the authority of *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (C. C. A.-5) affirming 44 B. T. A. 624, which, before the Board of Tax Appeals, rested principally upon *Helvering v. O'Donnell*, 303 U. S. 370, *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372, and *Marrs McLean v. Commissioner*, 41 B. T. A. 565.

In the *O'Donnell* case the taxpayer receiving the net profit payments was a stranger to the lease; under his contract he was entitled to money equivalent to a proportion of the net profits as the consideration received for the sale of his stock in the corporation which was the owner and operator of the lease. The decision (p. 371) stated that "as mere owner of the shares in the San Gabriel Company, respondent had no such economic interest". Similar cases are rarely encountered because the holder of the net profit right usually, as in the instant case, had a capital investment in the oil in place prior to the execution of the instrument.

[6a] *Blankenship v. U. S.*, 95 F. 2d 507; *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588; *Commissioner v. Kirby Petroleum Co.*, 148 F. 2d 80, reversed by Sp. Ct. January 28, 1946.

[6b] *Holly Development Co. v. Commissioner*, 93 F. 2d 146; *Commissioner v. Felix Oil Company*, 144 F. 2d 276; *Commissioner v. Anna Vickers Crawford*, 148 F. 2d 776, affirmed by Sp. Ct., in *Kirby* decision of January 28, 1946.

In the second case, the *Elbe Company* owned certain oil and gas prospecting permits, drilling agreements, leases, and equipment. The properties were producing oil in commercial quantities. On October 3, 1927, the company entered into a contract with Honolulu Consolidated Oil Company by which it sold, transferred, and conveyed all its right, title and interest in the properties to the Honolulu Company, which was to "have the sole ownership of and the right to sell or otherwise dispose of all oil and or gas and derivative products produced in, on or upon said properties", it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in Honolulu . . . and *Elbe* shall have no interest in or to any of said properties whatsoever". Honolulu agreed to pay *Elbe* $350,000 upon the execution of the agreement and, if Honolulu did not elect to abandon the purchase, the additional sums of $400,000 in each of the years 1928, 1929 and 1930, and the further sum of $450,000 in 1931. The foregoing sums totaled $2,000,000. After the time when Honolulu had been fully reimbursed from its sales of oil and gas produced from the properties for all expenditures made in the acquisition, development, and operation of the properties, *Elbe* was to receive one-third of the net profits, as defined in the contract, resulting from the continued production, if any, from the properties. *Elbe*, whose cost in the properties was less than $350,000, the amount of the down payment, reported the difference as taxable gain from a sale of the property in its returns for 1927. In its returns for 1928 and 1929, *Elbe* reported the cash receipts of $400,000 as ordinary income and claimed a deduction for depletion thereon, which allowance this Court denied.

The *Elbe* case differs from the instant case in the following respects:

1. *Elbe* sought the depletion allowance upon cash payments which were fixed sums payable without regard to production. Gulf's receipts are dependent solely upon production and therefore clearly come within the tests laid down for an economic interest in *Kirby v. Commissioner*; see page 9, *supra*.

2. The *Elbe* contract expressly stated the parties' intention to be that *Elbe* retained no interest. On the other hand, the Gulf "assignment is made subject to the following terms and conditions" which required development and sharing of the profits derived therefrom, re-assignment of the lease before its termination; that the parties understood that the contract was of limited duration is clearly shown by the concluding words "during the life of this agreement". (R. 39.)

3. *Elbe* transferred oil field equipment and flowing wells. Gulf's contract covered only oil and gas exploration rights in land yet to be proven by the taxpayer's efforts.

4. *Elbe's* provision for net profit payments did not relate to all of its transferor's net profits from operations on the properties conveyed by *Elbe*; the profit interest affected only those that might accrue after its transferee had recovered from earnings the $2,000,000 paid as the consideration for the purchase of the properties. Gulf's possibility of profit attached to every barrel of oil in place at the time of the execution of the instrument here involved.

Clearly, *Elbe's* transaction looked primarily to the sale of producing oil wells and the equipment necessary to

operate them; the predominating purpose was to obtain a large fixed sum to be received without regard to the production "as the result of a single transaction within the taxable year, as in the case of a sale of property." Cf. *Burnet v. Harmel*, 287 U. S. 103, 106; *supra*, p. 13; *infra*, p. 25. A secondary consideration was to obtain the net profit payments from the oil that might remain in place after the purchaser had earned enough to recover the whole of the purchase price. This situation is very much different than that obtaining in the present case where Gulf's only motive was to secure the exploitation of the land which was only potentially valuable and, if found productive, to have further development of the property. *Supra*, pp. 12 and 13.

In a case such as the present, where the only payments involved are dependent solely upon extraction and sale of the oil, there is no need to look to the contract and the surrounding circumstances to see if the instrument is a sale or a lease; it is enough that the recipient has an economic interest.[7] Where, however, as in the *Elbe* case depletion is claimed upon a cash payment not dependent upon production, it is necessary to determine the essential nature of the transaction as a sale or lease in order to give character to the cash as either proceeds from the sale of a capital asset or gross income from the property. The test as to such a cash payment is whether the transferor "severs his connection with production" (*Anderson v. Helvering*, 310 U. S. 404, 408; *supra*, page 8), or, as has been stated by counsel for the Commissioner, "whether the cash payment is a return of capital, or ordinary income from

[7] *Palmer v. Bender*; see p. 9, *supra*.

the property depends upon whether the recipient has a continuing interest in production" (Commissioner's brief in *Kirby v. Commissioner*, No. 56 This Term, p. 24, where the cases are summarized).

It is important to keep in mind that in the ordinary pattern of provisions for net profit payments, as in the usual stipulation for gross royalties, the possibility of profit extends to all of the oil in place at the time the right is retained or acquired. It is very apparent, therefore, that there is a distinction between such usual stipulations, and *Elbe's* provision which, if it ever accrued, would necessarily be applicable only to the oil in place at the time its vendee had already enjoyed net income from the property equal to the $2,000,000 purchase price. This distinction is, we believe, important only when a determination must be made of the character of a cash payment which is not dependent upon production but, at such time, it is very material. It was emphasized in the Commissioner's brief in the *Elbe* case (pp. 13-14) where it was asserted that there was no reasonable expectation that any profit payments would be made. As a matter of fact no net profit payments had been made in the six years which had elapsed when the case was heard by the Board of Tax Appeals (*Elbe Oil Land Development Co.*, 34 B. T. A. 333, 334) and the Board expressly refused to pass upon whether depletion would be allowable upon the net profit payments when and if any were made (p. 335). It follows, therefore, that *Elbe* had not only severed its connection with the production, but it was also highly speculative whether it would ever have any receipts arising out of the extraction of oil. Under all these circumstances

this Court was "unable to conclude that the provision for this additional payment qualified, in any way, the effect of the transaction as an absolute sale", *(Helvering v. Elbe*, 303 U. S. 372, 375.) The result, we believe, would have been no different if the provision for additional payments had been for a *gross* royalty payable only if and after the operator had reimbursed itself for its cost of acquisition. This is so because there is no essential difference between a gross royalty and one payable out of net profits[*] and, under either type of agreement, the interest in production is (under *Elbe's* facts) severed and might not revive. Thus, in *Bankers Mortgage Company v. Commissioner*, 142 F. 2d 130 (C. C. A. 5th), certiorari denied 89 L. ed. 41, depletion was denied upon cash received upon the execution of the contract because the mere fact that after thirty years there would be a possibility of accrual of a 14 10000 gross royalty to the taxpayer did not entitle the taxpayer to statutory depletion allowance before that situation materialized.

In this view, *Elbe* was not denied depletion upon the cash down payment because a provision for net profit payments is any less an economic interest than a gross royalty; or because it lacked technical title, or because it was not technically a sublessor; *Elbe* was denied the allowance for one reason only; namely, this Court could not conclude that a stipulation for payments relating only to the oil, if any, which might remain in place at a remote time in the future represented a continuing interest in production.

[*] "The lessors' economic interest in the oil is no less [than that reserved by a gross royalty] when their right is to share a net profit." *Kirby v. Commissioner, supra*, (p. 296).

In any event, there is a decided difference between the *Elbe* case where the transferor obviously sought a certain fixed sum in money as in the case of a sale of the property and the present case where Gulf's only motive was to secure income from development of the property.*

That the Tax Court (formerly the Board of Tax Appeals) has construed the *Elbe* decision as meaning that, in net profit payment cases, the practical consequences for payments of that type are to be ignored and that technical title, the form of the contract, and the legal relationship of the parties are to be determinative may be readily seen from the Tax Court's decisions. The line of demarcation drawn by the Tax Court in the earlier cases was based solely upon legal title. Thus, in *Marrs McLean*, 41 B. T. A. 565, the taxpayer assigned *all* of his title in three leases, only *three-fourths* of title in one lease (Gray lease; issue No. 2), but gave the assignee exclusive operating and management rights in the whole of this latter property. There was a provision for net profit payments from each of the four properties. The Tax Court held that depletion was allowable to the taxpayer only in respect of the lease where one-fourth of the title had not been conveyed. That the Tax Court still considers technical title and possession of an additional gross royalty determinative of the nature of a provision for net profit payments is clearly shown in *Estate of Dan A. Japhet v. Commissioner*, 3 T. C. 86, 92-93, where the Tax Court distinguishes the *Marrs McLean* case by stating:

> "In the instant case, petitioners did not assign to Humble a three-fourths interest in the sublease and

* Cf. *Burnet v. Harmel*, 287 U. S. 103, 106; *infra*, p. 25. Also see *supra*, pp. 12 and 13.

> retained for themselves an undivided one-fourth interest."

and goes on to distinguish the *Kirby* case as follows:

> "Our recent decision in *Kirby Petroleum Co.*, 2 T. C. 1258, is distinguishable. In that case the taxpayer in its assignment of the lease reserved to itself a one-sixth oil royalty, thus reserving to itself an interest in the oil in place. This fact, we held, brought the *Kirby Petroleum Co.* case within the rule followed as to the Gray lease in issue 2 in *Marrs McLean, supra.*"

However, *Kirby v. Commissioner*, *supra*, makes it clear that "the technical title to the oil in place is not important". The *Kirby* opinion also states that the reservation of royalties "would not show an economic interest in the oil not necessary for the payment of the royalties"[10] (p. 296, foonote 6) and that if "the only payment . . . made was the portion of the net income . . . it would be clear that such payment . . . would taxwise be rent or royalty paid by the lessees for the privilege of extraction". (p. 297.)

The Tax Court has also, on occasion, considered reversionary rights of importance. As pointed out by counsel

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[10] While Gulf did not retain a gross royalty for itself, it carved an overriding royalty out of the original lease interest for the benefit of a third party (R. 36). If this interest had been for Gulf's own benefit, the Tax Court clearly would have considered Gulf's net profit provision as an economic interest and not proceeds from a sale of the property. The Commissioner's brief in the *Kirby* case (pp. 21, 22) brings out forcibly that it is "untenable to hold that an interest in the operator's net profit may or may not represent a depletable interest depending upon whether the right to receive [gross] royalties has been retained".

for the Commissioner, three of such cases[11] are now pending below. In an earlier case, *Commissioner v. Felix Oil Co.*, 144 F. 2d 276 (C. C. A.-9), the taxpayer, owner of the land in fee, did not reserve a gross royalty but, like Gulf in the present case, kept only 50% of the net profits. *Felix* reserved the right to sell 50% of the oil, if it so elected, while Gulf has the right to purchase the entire production in our case. The Commissioner contended that *Felix* had made an outright sale and had no continuing interest in production. The Tax Court held, and the Circuit Court of Appeals affirmed, that *Felix* was entitled to an allowance for depletion. The chief difference between *Felix* and Gulf is that Gulf does not own the land in fee. However, it would seem that ownership of the surface of the land is quite immaterial and that Gulf has as clear a need and right to the depletion allowance.

The decisions of this Court do not seem to indicate that reversionary rights are of importance[12]. The Tax Court held in *Westley W. West, et al v. Commissioner*, 3 T. C. 431 affirmed by C. C. A.-5th in 150 F. 2d 723; certiorari denied dockets No. 667 et seq. this Term) that a reversion

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[11] Commissioner's supplemental memorandum on application for writ of certiorari in this case, page 3: *Innis v. Commissioner*, decided June 29, 1945 (1945 P-H T. C. Memo Decisions Service, par. 45246); *Williams Bar Dredging Company v. Commissioner*, decided June 30, 1945 (1945 P-H T. C. Memo Decisions Service, par. 45244); *Gracey v. Commissioner*, 5 T. C. 296, 301-303.

[12] Counsel for Commissioner has stated: "It may be observed that, generally speaking, the only practical difference between the rights of an assignor and a lessor is the reversionary interest of the latter. Since the usual oil and gas lease runs for as long as oil and gas may be produced in paying quantities, *the reversionary rights of a lessor to the oil in place are only of theoretical importance.* As is true in this case, the affirmative duties of the assignee may not be materially different from those of a lessee. Cf. *West v. Commissioner*, 150 F. 2d 723 (C. C. A.-5th), certiorari denied, January 28, 1946, Nos. 667, 668, 669 and 670, this Term". (Supplemental memorandum on application for writ of certiorari in this case, page 4, footnote 2.) (Italics supplied.)

was not an essential element in determining if the transaction was a lease or a sale. However, if they are considered as material, we wish to refer the Court to the statement of counsel for the Commissioner with respect to the Gulf contract to the effect "that the assignment here imposed certain drilling obligations on the assignee and required him to continue such operations on the land as would be required to continue the original lease in effect, if the assignee failed to fulfil his obligations, he was required to re-assign the lease to the assignor. Thus, the relationship between the assignor and the assignee was, in many respects, similar to that which exists between a lessor and lessee of an oil and gas lease".[13] The lease must be re-assigned to Gulf at least thirty days before the maturity of any obligation under the lease (R. 35), which gives Gulf a part of the term. It may be further noted that Gulf did not purport to convey the whole of the estate created by the original lease but, in addition to the provision for a share of profits, specifically excepted (a) an overriding oil royalty for the benefit of a third party (R. 36), and (b) all sulphur rights (R. 38). Thus, the instrument here had every element of a contract of sublease.

The soundness of the result reached in the *Felix* decision is certainly not open to doubt, because, as this court has said (*Kirby v. Commissioner*, *supra*, p. 297):

> "If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessors by the lessees was the portion of 'net income' paid under the leases, it would be clear that such payment of 'net income' would taxwise be rent or royalty paid by the lessees for the privilege of extraction."

[13] Supplemental memorandum on application for writ of certiorari in this case, page 4.

Accordingly, since Gulf stands in the same position in every material aspect, there would seem to be no logical reason why Gulf, which is entitled to secure the profits throughout the term of the lease, should, by the effect of the decision here, be required or permitted to treat the transaction as a sale of the natural resources in place. The theory underlying the allowance for depletion is that a gradual sale is made and the allowance represents the reduction in the reserve from which the produce is taken. *U. S. v. Ludey*, 274 U. S. 295, 301. The capital gains provisions and limited surtax rates on sales of oil properties were not intended to cover deals which look to the working of the mineral deposit for income to be realized gradually over the life of the deposit and according to the actual results obtained from operations. *Burnet v. Harmel, infra; West v. Commissioner*, 150 F. 2d 723 (C. C. A. 5). Thus, in *Burnet v. Harmel*, 287 U. S. 103, 106, it was stated:

> "But notwithstanding this incidental transfer of ownership, *it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act.* Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time consuming operation and *the payments* made by the lessee to the lessor *do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.*" (Italics supplied.)

The decisions below do, of course, cause the petitioner to bear a heavy burden by including Gulf's profit payments in its taxable income which admittedly petitioner

would not be required to do if it had acquired the privilege of extraction from a landowner or from an assignor who possessed a gross royalty. However, as is frequently the case, the decision cuts both ways. This is so because, if the petitioner's payments are purchase price for oil in place, the payments in Gulf's hands represent proceeds from the sale of oil in place and, no doubt, are entitled to the preferential treatment accorded capital gains. Under these circumstances, we are not only unable to understand why the taxpayer should bear a greater relative tax burden than other producers who acquired their privilege of extraction from landowners or from one who also possessed a gross royalty, but we also are unable to understand why Gulf, which enjoys 50% of the net income, should pay tax upon that 50% at capital gains rates while the taxpayer pays upon 100% of the net income at ordinary rates but enjoys only 50% of the income. Considering that Gulf's income will continue until the exhaustion of the oil deposit, that some expenses are not taken into account in computing its 50% of the profits, and that Gulf has the reversion of the oil rights, it seems clear that Gulf's interests in the oil in place are actually more extensive than those of your petitioner. Petitioner cannot retain Gulf's one-half of the net income; it derives no more benefit from Gulf's share than the operators who share net income with the landowners. The economic consequences to your petitioner are precisely the same whether or not Gulf is technically a sublessor; they would be no different if Gulf also possessed a royalty payable out of gross production or the fee interest in the land.

This Court has never held that receipts which depend solely upon the production of oil represent proceeds from the sale of the property; to the contrary, it has always held such receipts are gross income from the property.

CONCLUSION.

In view of the foregoing, the judgments of the Tax Court and the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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APPENDIX.

Revenue Act of 1934.

SEC. 22. GROSS INCOME.

(a) General Definition. "Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. A. 669, 1940 Edition.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity

(26 U. S. C. A. 671, 1940 Edition.)

(m) Depletion. In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance

for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

(26 U. S. C. A. 673, 1940 Edition.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(b) Basis for Depletion—

(3) Percentage depletion for oil and gas wells. In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(26 U. S. C. A. 702, 1940 Edition.)

Revenue Act of 1936.

The provisions of Sections 22(a), 23(a), 23(m) and 114(b)(3) of the Revenue Act of 1936 are identical with the corresponding sections of the Revenue Act of 1934.

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED,
Petitioner.

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1945

No. 361

BURTON SUTTON OIL COMPANY, INCORPORATED,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

The issue here is focused on the Commissioner's present contention that "* * * an interest in net profits to liquidate a cash payment [made without regard to production] which is depletable as a bonus when the recipient has continuing rights to share in production by way of an oil royalty, but is not depletable by the recipient or excludable by the payer when it is not associated with a royalty interest" (Br. 24) and the taxpayer's primary position that "an economic interest is no less than an oil royalty when the right is to share a net profit."

The Commissioner's argument in his *Kirby* brief (p. 21) was:

> "We submit that it is altogether untenable to hold that an interest in the operator's net profits may or may not represent a depletable interest, depending upon whether the right to receive royalties has been retained. A royalty, representing the right to share in the production of the oil, clearly gives rise to gross income from the sale of oil and is depletable. But how that interest becomes enlarged to include a more extensive one in the production of oil merely because there is an additional right to share in net profits, or how a share of net profits represents a share of the production of oil only when there is another different right to a portion of production through oil royalties, is exceedingly difficult to comprehend."

Footnote 6 in the *Kirby* decision was in apparent agreement because it stated:

> "While the reservation of royalties shows an economic interest in the oil necessary for the satisfaction of the royalties, such reservation would not show an economic interest in oil not necessary for the payment of the royalties. But see *Japhet* v. *Commissioner of Internal Revenue*, 3 T. Ct. (F.) 86."

The Commissioner's brief in *Kirby* (p. 21) further stated:

> "We submit that there is no reason why a share in the operator's net earnings should give rise to a depletable interest in the oil produced; but if such reason does exist, the net profits should not be chameleonic, their character changing with the other interests which the assignor or lessor may possess."

and by way of footnote illustrated the capricious results which would obtain from the establishment of the rule for

which the Commissioner now contends in the present case.

Again, we believe the *Kirby* decision accepted the Commissioner's argument because it was stated:

> "If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessees by the lessees was the portion of 'net income' fixed under the leases, it would be clear that such payment of 'net income' would taxwise be rent or royalty paid by the lessees for the privilege of extraction."

The *Kirby* opinion certainly means more than that net profit payments are like cash payments which do not depend upon production. The basis for the decision, in our opinion, is that

> "The lessors economic interest is no less [than a gross royalty] when the right is to share a net profit."

Therefore, Gulf having the right to net profit payments, whether it became a technical sublessor or not, retained an economic interest identical with that of a lessor. Cf. *Palmer v. Bender*, 287 U. S. 551, 558.

To our discussion of the *O'Donnell* case (page 15 of brief) we wish to add that the Court's view of this case in the *Kirby* decision seemed to be "since O'Donnell was an entire stranger to the lease, the payments cannot in any view be regarded as rent." (Commissioner's brief, page 44, *O'Donnell* case, No. 436 October, 1937 Term.) The same result applies even if the consideration is measured by gross production. *Haines v. U. S.* (Court of Claims), 50 F. Supp. 238.

The grounds upon which we distinguish the *Ellis* case (brief pages 17-20) are not "infirm", as the Commissioner now contends (Br. 26) but are the very same reasons he urged to this Court in obtaining the judgment. The Com-

missioner's brief in the *Elbe* case (docket No. 446 October 1937 Term), stated:

> "*Pro tanto* the transaction constitutes a purchase of an economic and legal interest in the oil in place and this regardless of the nature of the parties relationship once Honolulu has reimbursed itself and the provisions of paragraph 8 [net profit payment after contingencies] became operative" (p. 20).
>
> "In the view of the case which has been taken the nature of the interest acquired by Elbe under the provisions of paragraph 8 is of no consequence" (p. 23).

It is not at all necessary to determine here whether a cash payment not dependent upon production is depletable. The issue here, unlike the *Elbe* case, is whether actual receipts dependent upon production are depletable.

The Tax Court interprets the *Kirby* case as requiring an allowance for depletion where the net profit payment is the *sole* interest in production. *The Proctor and Gamble Manufacturing Company* v. *Commissioner*, Docket No. 3338, February 18, 1946 (C. C. H. Tax Court Decisions, p. 23257) allowance to a landowner-lessor; and *William B. Murphy, et al.* v. *Commissioner*, 6 T. C. No. 42, February 28, 1946 (C. C. H. Tax Court Decisions, p. 23264) allowance to former owner of lease. The *Murphy* case cannot be distinguished from Gulf's position here.

The Commissioner now urges that adoption of a rule that net profit payments are depletable only when the recipient has a gross royalty "has the obvious advantage of avoiding undue administrative complexity" (Br. 24). (Compare, however, his *Kirby* brief pages 21 and 22.) In our view the statue may be administered just as easily under the Tax Court's interpretation of the *Kirby* decision.

We respectfully submit that there must be regard for the "practical consequences of the provision for payments" (*Anderson* v. *Helvering*, 310 U. S. 403, 411). Unless the door is to be opened for "sales" of income producing properties of all sorts for shares of net profits, whereunder the "vendor" is to enjoy, at the same time, both the economic advantage of income from the property and taxation at capital gains rates, decisions must have regard for realities. In order to maintain his position here the Commissioner would have a rule established under which Gulf has "sold" its capital investment.[1] If that is true, Gulf is entitled to first recover its entire capital investment and then have its remaining receipts accorded preferential treatment as capital gains. Thus, Gulf, after a tax-free recovery of its capital investment, would have its tax limited to twenty-five (25) per cent on its remaining receipts. Why should Gulf enjoy a tax rate of 25% on 50% of the income while the taxpayer here is also chargeable with 100% and can be required to pay rates as high as 80%?

Gulf's sole purpose was to obtain income from the operation of the wells, it has such income, and we think that it should, like the taxpayer, bear taxes upon the income as such. Indeed, periodic (monthly) payments which must be made (1) as long as the payer continues to use the property

---

[1] While the decision here must, of necessity, determine whether Gulf "sold" its capital investment in the oil, the Commissioner (Br. 16, 25) and the taxpayer (Br. 8, 12, 18) agree that this question should be decided by the practical character of the provision for payment and not by the kind of legal relationship of the parties nor how the instrument itself might be classified, without regard to the practical consequences of the provisions for payments, as an "assignment" or "sublease." If, however, the Court should disagree with this principle, the Commissioner (Br. 13) contends that the instrument is essentially an outright assignment while the taxpayer's view (Br. 12, 13, 24) is that the transaction was essentially a sublease.

and (2) as a condition of the contract granting the use, partake of the quality of rent and require corresponding tax consequences.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1945

Nos. 361 and 362

BURTON-SUTTON OIL COMPANY, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 54–74) [1] and the dissenting opinion (R. 74–75) are reported at 3 T. C. 1187. The opinion of the Circuit Court of Appeals (R. 87–93; C. R. 110–116) and the

[1] Record references to the transcript of record in docket No. 11,275 in the Circuit Court of Appeals (No. 361 here) are referred to with the designation "R." References to the transcript in docket No. 11,285 (No. 362 here) are designated "C. R." The cases were consolidated in the Circuit Court of Appeals for hearing and disposition.

dissenting opinion of Judge Lee (R. 93–96; C. R. 116–119) have not been reported.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on July 6, 1945. (R. 97; C. R. 119–120.) The petitions for writs of certiorari were filed on August 23, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. The taxpayer acquired the working interest in an oil and gas lease, agreeing to pay 50 per cent of its net profits to the assignor of its transferor, and to pay oil royalties and overriding royalties to others. Did the court below err in affirming the decision of the Tax Court that the taxpayer was not entitled to exclude or deduct from its taxable income the share of its net profits so paid?

2. After the taxpayer had acquired the working interest in an oil and gas lease and had drilled a number of producing wells, a question arose whether the boundary lines of the property had been correctly located and whether the taxpayer's producing wells were situated on property belonging to its lessor. The taxpayer incurred expenses in establishing that the correct boundary lines were such that its working interest extended to the property in question. Did the court below err

in reversing the decision of the Tax Court and in holding that the expenses were not deductible as ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1936?

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and Regulations involved are set forth in the Appendix, *infra*, pp. 16–18.

STATEMENT

A portion of the facts in these cases (which reached the court below by cross-appeals) was stipulated by the parties. (R. 45–54.) All the stipulated facts were found, either expressly or by reference, by the Tax Court as stipulated. (R. 66.)

The taxpayer is a corporation organized in 1933 and doing business and having its principal office in Louisiana. Its books were kept and its tax returns were prepared on the accrual basis. (R. 57–58.) In 1933 taxpayer acquired the working interest in a certain oil and gas lease in Louisiana which had been executed by the Cameron Parish School Board, as lessor. (R. 58.) The taxpayer's interest in this oil and gas lease was procured from J. G. Sutton, who had obtained his interest from the Gulf Refining Company of Louisiana, referred to herein as Gulf. (R. 58.) The agreement between Sutton and Gulf, which was acquired by taxpayer, provided that Gulf (R. 46)—

> has sold, conveyed and transferred, * * * all oil and gas rights, titles, interests or

privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of Section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.

Paragraph 1 of the agreement set forth the drilling obligations of the grantee. (R. 46.) Paragraphs 2 and 3 provided that the grantee should pay all oil and gas royalties as well as overriding royalties; after being reimbursed for all expenses from the remaining oil, the grantee was to pay the grantor 50 per cent of his net earnings from the wells. (R. 47, 59–60.)

Paragraph 5 of the contract specified what costs and expenses could be deducted from the gross proceeds before division of the net profits was required to be made. (R. 48–49, 60.) Paragraph 7 provided that Gulf should not be obligated to pay any of the costs or expenses incurred by the grantee in his operations under the agreement. (R. 49–50, 60.) Paragraph 8 provided that the grantor retained all rights to sulphur in the property. (R. 50.) The final paragraph of the agreement specified the manner in which the oil produced from the land was to be sold and gave Gulf the right to purchase the oil at the average posted price, if it so desired. (R. 50–51.)

The Commissioner determined that the share of the taxpayer's net profits which was paid to Gulf was neither excludable nor deductible from taxpayer's taxable income since it represented part of the capital cost of the taxpayer's oil and gas interest, recoverable through depletion. (R. 14–15, 61.) The Tax Court upheld the Commissioner's determination in this respect and on taxpayer's petition for review its decision on this issue was affirmed by the Circuit Court of Appeals, Judge Lee concurring.

The taxpayer drilled about 19 producing wells under the lease mentioned above and had an annual gross income therefrom in excess of $1,000,000 during the years 1937 and 1938. (R. 63.)

Preparatory to a proposed proceeding by the United States to acquire certain land in the area by condemnation, the Bureau of Biological Survey of the Department of Agriculture had made a survey in 1936. The effect of this survey was to move all north and south section lines in the area several miles to the west. This, if officially accurate, would have resulted in a complete lack of title in the State of Louisiana and the Cameron Parish School Board to the territory on which taxpayer's producing wells were actually located. Also, the taxpayer would have had no rights in the area in which exploitation had been taking place. (C. R. 7–9, 13–14; R. 63–65.) Instead,

the taxpayer would have had a valueless lease to barren prairie land, and the Orange Cameron Land Company would have been the owner of the property where the oil deposits were located (C. R. 9, 14, 19; R. 64–65.)

The taxpayer employed a law firm to establish that the survey of the Department of Agriculture was a miscalculation and that the one under which the taxpayer claimed title to the underlying oil and gas was exact. (R. 64–65.) The United States filed its petition for condemnation in 1937, describing the land to be taken in accordance with the Department of Agriculture's survey. (R. 62–63.) The condemnation petition provided that the estate to be appropriated for the public use was the full fee simple title, subject to existing mineral, gas, and oil rights. (C. R. 44.) The taxpayer successfully proved to all interested parties that the section lines established by the Department of Agriculture's survey were inaccurate and that the proper boundary lines were those under which the taxpayer's lessor claimed. (R. 64–65.) The taxpayer, the Cameron Parish School Board, and the State of Louisiana were parties to the condemnation proceeding; in accordance with an agreement of all interested parties, the judgment of condemnation described the property taken in accordance with the existence of the section lines as contended for by taxpayer. (R. 65.)

During the taxable year ended February 28, 1938, taxpayer expended $27,564.61 for legal expenses in this matter. It deducted this amount in its tax return as an ordinary and necessary business expense, but the deduction was disallowed by the Commissioner on the ground that the disbursements were capital expenditures. (R. 65–66.) The Tax Court ruled, five judges dissenting, that these outlays were deductible as ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1936. On the Commissioner's petition for review the Circuit Court of Appeals, Judge Lee dissenting, reversed the Tax Court on this issue, holding that the expenditures were capital in nature and not deductible under Section 24 (a) (2) of the Revenue Act of 1936 and Article 24–2, Treasury Regulations 94.

DISCUSSION

1. The Circuit Court of Appeals decided that the taxpayer could not exclude from its taxable gross income or deduct as a business expense certain payments which it made, consisting of 50 percent of its net profits derived from a working interest in an oil and gas lease. The taxpayer, in acquiring its working interest, became obligated to make these payments to its transferor's assignor, and also became obligated to pay certain underlying and overriding oil royalties. (R. 59–60.)[2]

[2] See footnote 1, *supra*.

In holding that the net profit payments could not be excluded from the taxpayer's gross taxable income, the decision in this case would appear to conflict in principle with the decisions of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner v. Felix Oil Co.*, 144 F. 2d 276, and in *Commissioner v. Crawford*, 148 F. 2d 776, certiorari applied for, No. 197, this Term. Because of this conflict and because of the granting of certiorari on May 21, 1945, in *Kirby Petroleum Co.* v. *Commissioner*, No. 56, this Term, the Commissioner, while believing the decision below to be right, does not oppose the granting of a writ of certiorari in No. 361 to review this issue.

The issue presented by the *Kirby* and *Crawford* cases is whether a lessor is entitled to a deduction for depletion with respect to net profit payments received from his lessee. While formal distinctions might be drawn between the issue there whether the net profits received constitute a depletable interest in the lessor and the issue here whether net profits paid by an assignee constitute part of his income from the property, we believe that it is well settled that such formal distinctions have no material bearing on the question and that the same basic principles determine to whom the gross income from the property is attributable for tax purposes and by whom the depletion deduction may be taken with respect to such gross income. *Anderson* v. *Helvering*, 310 U. S. 404,

407, 411. Accordingly, the ultimate decision of this Court in the *Kirby* case may be decisive of the exclusion issue presented in No. 361.

2. In No. 362, the court below decided that the taxpayer was not entitled to a deduction for certain expenditures since they did not constitute ordinary and necessary business expenses under Section 23 (a) of the Revenue Act of 1936 (Appendix, *infra*). These expenses, which the court below held to be of a capital nature under Section 24 (a) (2) of the Revenue Act of 1936 and under Article 24–2, Treasury Regulations 94 (Appendix, *infra*), were incurred by the taxpayer in an effort to prove that a survey made by the United States Government was erroneous. The Government's survey, if accurate, would have moved the section lines in this particular area in such a way that the oil and gas wells which were operated by taxpayer would have been located on property belonging to someone else and the taxpayer's lease would have become valueless. (R. 63–65; C. R. 7–9, 13–14, 19.) The taxpayer succeeded in proving that the Government's survey was in error and that the survey under which it claimed was correct. As the court below properly observed (C. R. 112), the expenditures were not made to protect taxpayer's interest against condemnation, for the condemnation petition expressly excluded mineral leases (C. R. 44, 54–55); the expenditures were made to confirm title, and under the ap-

plicable Regulation (*infra*, p. 18) they constitute capital expenditures and not deductible business expenses.

The decision on this issue does not present a question requiring further review by this Court.

A. The court below did not, as alleged (Pet. 3, 4–5, Br. 7, 8–9),[3] substitute its own findings of fact or its own inferences for those expressly made by the Tax Court. Thus, the Tax Court found (R. 63–64, 65):

> The Bureau of Biological Survey of the Department of Agriculture made a survey of the 139,000 acres preparatory to acquiring the land. Early in 1936 petitioner learned that the survey made by the Bureau of Biological Survey had the effect of moving all north and south section lines in Township 14 South, Range 13 West, about three miles to the west. This would have had the effect of leaving the oil field which petitioner had developed in what it contended was Section 16 in a section three miles to the east.
>
> * * * * *
>
> In the above-mentioned suit there had been no question as to the validity of petitioner's lease with the Cameron Parish School Board. The only question involved in so far as petitioner was concerned was the location of Section 16, Township 14 South,

[3] This and succeeding references are to the petition and supporting brief in No. 362.

> Range 14 [?] West, and the boundaries thereof. If Section 16 were located on the ground where the Bureau of Biological Survey contended it was, petitioner would have a lease on barren prairie land with no production, whereas if it were where petitioner contended it was the lease would be on land with 19 producing wells. If petitioner had lost, it would have lost its entire oil field and the income therefrom. The final judgment placed the boundary of said Section 16 just as petitioner had contended it should be placed, namely, in accordance with the survey made by Shutts in 1924 and 1925.

It is significant that the taxpayer has never contended, and does not now contend, that its right to extract oil from the leased property was subject to appropriation in the condemnation proceeding or that its expenditures were made to prevent or resist a threatened taking of this right. Any such contention would contradict the established facts. We agree with the taxpayer's assertion (Br. 10) that "The expenditures went solely to prove the error in the Government survey."

To the extent that the Tax Court, in its opinion, relied on the assumption that the taxpayer's property would have been "taken" if the United States had prevailed in its original condemnation petition (R. 73) or assumed that the expenditures were incurred because the taxpayer's efforts were directed "to prevent its property being taken"

(R. 74), it manifestly disregarded its own findings of fact and the undisputed evidence.

The taxpayer also contends (Pet. 4, Br. 7, 8, 9) that the Circuit Court of Appeals, in concluding that the condemnation proceeding did not threaten to take any property rights of the taxpayer, disregarded the stipulation entered into by the parties, particularly the provision that the taxpayer incurred "legal expenses in resisting proceedings instituted by the United States of America on certain of its property." (R. 52–53.) The stipulation, it may be noted, does not state that the taxpayer resisted an appropriation or taking of its property interest. We do not believe that any inconsistency exists or that any was intended, especially since the stipulation was filed at the hearing of October 25, 1943 (R. 45), after the testimony and exhibits (taken by deposition) introduced by the taxpayer had been filed with the Tax Court on October 8, 1943 (C. R. 5). But if there were any inconsistency, the taxpayer could scarcely complain if the facts were taken to exist as indisputably shown by its own evidence (C. R. 5–93), especially since the Tax Court itself found the facts in accordance with that evidence, as shown from the excerpt quoted above.

We submit that the Circuit Court of Appeals did not exceed its powers of review under Section 1141 (c) of the Internal Revenue Code (26 U. S. C. 1940 ed., Sec. 1141). It accepted the

facts as they were expressly found by the Tax Court. Whether the applicable provisions of the statutes and Regulations preclude the deduction in such circumstances is a matter within the province of the reviewing tribunal. *Trust u/w of Bingham* v. *Commissioner,* decided by this Court June 4, 1945, not yet reported. Moreover, to the extent that the Tax Court, in its opinion, made assumptions which lacked any warrant either in the record or in its own findings, the conclusions which it drew concerning the nature of the expenditures were not entitled to the same deference which they ordinarily would receive.

B. No conflict in decisions is presented. *Commissioner* v. *Reakirt,* 84 F. 2d 996 (C. C. A. 6th), affirming *per curiam* 29 B. T. A. 1296, relied on by the taxpayer (Pet. 4, 5, Br. 9–10), differs from the present case in every material respect. In the *Reakirt* case there was no issue respecting the taxpayer's title to the property. Here, the only matter with which the taxpayer was concerned related to the validity of its title to the underlying oil in the place where its wells had been drilled; the expenses were incurred to remove the cloud which had been cast on its chain of title by the Government's survey. In the *Reakirt* case the expenses were incurred to prove that the condemning authority had no legal right to take the taxpayer's property. In the present case there was no dispute concerning the authority of the

United States to take whatever surface land it needed and the taxpayer here never contested any taking by the United States. In the *Reakirt* case, if the taxpayer had not prevailed in the litigation, he would have received fair compensation from the condemning authority for the taking. If the taxpayer here had not been able to prove the invalidity of the Government's survey, it would have lost its rights to the oil where located and, instead, would only have had a valueless lease to barren ground. By proving that the Government's survey was inaccurate, the taxpayer here was able to perfect its title to the underlying oil.

Thus, the *Reakirt* decision has no bearing on expenses incurred to perfect title by removing a cloud which has been cast on it. Although we believe that the *Reakirt* case itself was decided erroneously, it does not conflict with the decision in the present case. In addition, it should be observed that the provisions of the applicable Regulations were less clearly controlling in the *Reakirt* case than they are in the situation presented here. Indeed, Article 24–2, Treasury Regulations 94 (Appendix, *infra*) expressly declares that "The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense." The applicable decisions unanimously support this provision of the Regulations by holding that expenditures incurred to establish the validity of one's title or to defend against attacks made upon

it are not deductible business expenses. *Jones' Estate* v. *Commissioner*, 127 F. 2d 231 (C. C. A. 5th); *Farmer* v. *Commissioner*, 126 F. 2d 542 (C. C. A. 10th); *Owens* v. *Commissioner*, 125 F. 2d 210 (C. C. A. 10th), certiorari denied, 316 U. S. 704; *Moynier* v. *Welch*, 97 F. 2d 471 (C. C. A. 9th); *Brawner* v. *Burnet*, 63 F. 2d 129 (App. D. C.); *Croker* v. *Burnet*, 62 F. 2d 991 (App. D. C.); *Blackwell Oil & Gas Co.* v. *Commissioner*, 60 F. 2d 257 (C. C. A. 10th); *Hutchings* v. *Burnet*, 58 F. 2d 514 (App. D. C.); *Murphy Oil Co.* v. *Burnet*, 55 F. 2d 17 (C. C. A. 9th), affirmed without consideration of this point, 287 U. S. 299. See also *Schwabacher* v. *Commissioner*, 132 F. 2d 516 (C. C. A. 9th). The decisions in *Kornhauser* v. *United States*, 276 U. S. 145, and *Commissioner* v. *Heininger*, 320 U. S. 467 (Pet. 5, Br. 10), plainly do not deal with the question of the capital nature of an expenditure of this kind.

CONCLUSION

The Commissioner does not oppose the granting of a writ of certiorari in No. 361 (issue 1, *supra*). The granting of certiorari in No. 362 (issue 2, *supra*) is opposed since the decision below is correct and no conflict of decisions is presented; accordingly, the petition therein should be denied.

Respectfully submitted.

HAROLD JUDSON,
Acting Solicitor General.

SEPTEMBER 1945.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases

to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * * *

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—

* * * * * *

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

* * * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * * *

(b) *Basis for Depletion.*—

* * * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * * *

The provisions of Sections 23 (m) and 114 (b) (3) of the Revenue Act of 1934, c. 277, 48 Stat. 680, are identical with the corresponding sections of the Revenue Act of 1936.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 24–2. *Capital expenditures.*— Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. (See section 23 (l).) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. * * *

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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 361

BURTON-SUTTON OIL COMPANY, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

SUPPLEMENTAL MEMORANDUM FOR THE RESPONDENT

The Commissioner's memorandum, in not opposing the granting of a writ of certiorari in this case, pointed out (p. 9) that the decision in *Kirby Petroleum Co.* v. *Commissioner*, No. 56, this Term, might be decisive of the issue presented here. We believe that the decision entered in the *Kirby* case on January 28, 1946, does not determine the controversy in this case, that the decision below may conflict in principle with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276, and that the issue is an important one in the administration of the revenue which ought to be resolved

by this Court. Accordingly, we urge that the petition for certiorari be granted.

In the present case, the taxpayer acquired the working interest in an oil and gas lease, undertaking to pay 50 percent of its net profits from operations to its transferor's assignor, the Gulf Refining Company, hereafter referred to as Gulf. It also undertook to pay overriding and underlying oil royalties to the original lessor and lessee. The Tax Court and the court below held that the taxpayer could not deduct or exclude from its taxable income the net profit payments made to Gulf. Accord: *Quintana Petroleum Co.* v. *Commissioner*, 143 F. 2d 588 (C. C. A. 5th). The decisions below, of necessity, also determine that Gulf may not deduct the depletion allowance with respect to the net profit payment received by it from the taxpayer. In contrast stands the decision in the *Felix* case, where, although the lessor, as is true of Gulf in the present case, did not reserve any oil royalties, it was, nevertheless, held to be entitled to the depletion allowance with respect to certain net profit payments received from its lessee.

The present case may be distinguishable from the *Kirby* case in two separate respects, or those distinctions may be entirely immaterial, depending upon the precise grounds upon which the *Kirby* case was decided. In this case, Gulf's only interest in the oil in place was returnable from net profits; in the *Kirby* case the lessor was en-

entitled to a share of gross production by way of oil royalties and also to a portion of the net profits. The Tax Court has considered the reservation of an oil royalty to be an important element in deciding whether the right to a share of net profits evidences a depletable interest. Cf. *Estate of Japhet* v. *Commissioner*, 3 T. C. 86, 91–93; *Crawford* v. *Commissioner*, decided March 24, 1944 (1944 P–H T. C. Memorandum Decisions, par. 44,098). We are not wholly clear as to whether, under the *Kirby* opinion, the absence of an oil royalty in this case is material so that Gulf is to be denied the depletion allowance with respect to the net profits received (and the payments made are to be included in the taxpayer's income) on the ground that Gulf does not have a royalty interest in the lease. Insofar as the *Kirby* opinion states that (slip opinion, p. 6) "a share in 'net profits', dissociated from an economic interest, does not entitle the holder to a depletion allowance", it tends to support the decision below. Accord: *Helvering* v. *O'Donnell*, 303 U. S. 370; *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372. On the other hand, the *Kirby* opinion also states (fn. 6, slip opinion, p. 4) that a royalty interest "would not show an economic interest in oil not necessary for the payment of the royalties," that (slip opinion, p. 4) "The lessors' economic interest in the oil is no less [than that reserved by an oil royalty] when their right is to share a net profit," and that,

even if the only payments made by a lessee consisted of a portion of net profits, the payments would be deductible by the lessee as (slip opinion, p. 5) "rent or royalty paid * * * for the privilege of extraction." These statements would tend to support the theory that, despite the absence of a royalty interest, Gulf's interest is a depletable one and that, contrary to the decisions of the courts below, the payments made by the taxpayer are deductible.

The decision below might also be distinguishable on the ground that the working interest here was transferred by an assignment rather than a lease. The Tax Court, on occasion, has considered this an important factor. See *Innis* v. *Commissioner*, decided June 29, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,246); *Williams Bar Dredging Co.* v. *Commissioner*, decided June 30, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,244); *Gracey* v. *Commissioner*, 5 T. C. 296, 301–303.[1] The opinion in the *Kirby* case would seem to negate the fact that the technical difference between an assignment and a lease is of controlling significance since it follows the earlier decisions of this Court to the effect that (slip opinion, p. 3): "The technical title to the oil

[1] The *Williams Bar Dredging Co.* and *Gracey* cases are now pending on appeal in the Circuit Courts of Appeals for the Ninth and Fifth Circuits respectively; whether the Government should appeal from the *Innis* decision is now under consideration.

in place is not important. Title in a case of a lease may depend upon the law of the state in which the deposit lies." In this respect, the difference under state law between the legal relationship of an assignor or a lessor to the oil in place would not be of any significance and the decision below would not be distinguishable from the *Kirby* case because Gulf was an assignor rather than a lessor.[2] However, the *Kirby* opinion also distinguishes the leases there involved from cases where net profits from production have been retained, but a "sale" of the oil in place has been made (slip opinion, p. 6). In this view, should an assignment be considered as effectuating a sale of the assignor's interest, and if this case should turn on the fact that the transfer here was denominated an "assignment", the decision below would be correct. However, we wish to call the Court's attention to the fact that the assignment here (R. 59) imposed certain drilling obligations on the assignee and required him to continue

[2] It may be observed that, generally speaking, the only practical difference between the rights of an assignor and a lessor is the reversionary interest of the latter. Since the usual oil and gas lease runs for as long as oil and gas may be produced in paying quantities, the reversionary rights of a lessor to the oil in place are only of theoretical importance. As is true in this case, the affirmative duties of the assignee may not be materially different from those of a lessee. Cf. *West* v. *Commissioner*, 150 F. 2d 723 (C. C. A. 5th), certiorari denied, January 28, 1946, Nos. 667, 668, 669, and 670, this Term.

"such operations" on the land as would be required to continue the original lease in effect; if the assignee failed to fulfill his obligations, he was required to reassign the lease to the assignor. Thus, the relationship between the assignor and assignee was, in many respects, similar to that which exists between a lessor and lessee of an oil and gas lease. Accordingly, if the decision in the *Kirby* case rested upon the fact that the recipient of the net profit payments there was a lessor and that the lease did not amount to a sale of the oil in place, it is necessary to decide whether the relationship between the parties here is more closely related to that which existed in the *Kirby* case or that which obtained in *Helvering* v. *Elbe Oil Land Co., supra,* where a share of net profits was reserved, but the transaction took the form of a sale.

CONCLUSION

In view of the foregoing, it is respectfully urged that the petition for a writ of certiorari be granted.

Respectfully submitted.

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FEBRUARY 1946.

U. S. GOVERNMENT PRINTING OFFICE 1946

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (R. 42–58) is reported at 3 T. C. 1187. The opinion of the Circuit Court of Appeals (R. 66–72) is reported at 150 F. 2d 621.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on July 6, 1945 (R. 76). The petition for a writ of certiorari was filed on August 23, 1945, and was granted on February 11, 1946 (R. 78). The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer who acquired the working interest in an oil and gas lease, agreeing to pay 50 percent of its net profits to the assignor of its transferor and to pay oil royalties to others, may exclude or deduct from its gross taxable income an amount equal to the net profits payments.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 32–36.

STATEMENT

The facts in this case were stipulated by the parties (R. 34–41), and were found by the Tax Court in accordance with the stipulation (R. 51).

The taxpayer is a corporation, organized in 1933 and having its principal office in Louisiana where it carried on its business. Its books were kept and its tax returns were prepared on the accrual basis (R. 34–35, 44). In 1933, the taxpayer acquired the working interest in a certain oil and gas lease in Louisiana which had been executed by the Cameron Parish School Board, as lessor (R. 35, 45). The taxpayer's interest in this lease was procured, by contract, from J. G. Sutton, who had obtained the working interest from the Gulf Refining Company of Louisiana, referred to

herein as Gulf. (R. 35, 45). The agreement between Sutton and Gulf, which was acquired by the taxpayer, provided that Gulf (R. 35):

> has sold, conveyed and transferred * * * all oil and gas rights, titles, interests or privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of Section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.

The agreement, which was termed an "assignment", provided, in Paragraph 1 (R. 35–36), that the grantee was to commence drilling operations within 30 days and to continue with reasonable diligence in an effort to find oil or gas in paying quantities. After the completion of the first well, the grantee was obligated to continue—

> such operations on said land as may be necessary to continue said lease in full force and effect. If, after completing said well, Grantee shall desire to cease operations on said land, he shall, upon demand, reassign said lease to Grantor not less than thirty days prior to the maturity date of any obligation accruing after the date of the cessation of his operations on said land.

Paragraphs 2 and 3 provided that the grantee should pay the royalties provided for in the original lease, as well as an overriding royalty to the

original lessee, together with all expenses of operations. After having paid the underlying and overriding royalties, and after having been reimbursed from the proceeds of the oil and gas produced for all expenses of operation, the grantee was obligated to account and pay to the grantor 50 percent of the remaining proceeds (R. 36, 46).

Paragraph 4 provided when settlement should be made with Gulf, and Paragraph 5 specified in detail what costs and expenses could be deducted from the gross proceeds before division of the net profits was required to be made (R. 36–38, 46). Paragraph 7 provided that Gulf should not be obligated to pay any of the costs or expenses incurred by the grantee in his operations under the agreement (R. 38, 46). Paragraph 8 reserved to the grantor all sulphur rights in the property (R. 38, 46–47). The final paragraph specified the manner in which the oil produced on the land was to be sold, and gave Gulf the right to purchase the oil at the average posted price, if it so desired (R. 38–39, 47).

During the fiscal years ending on the last day of February, and pursuant to Paragraph 3 of the contract, the taxpayer paid the following sums to Gulf as its share of the net profits (R. 39–47):

1936	$17,408.10
1937	232,408.94
1938	286,128.28

The taxpayer deducted the above amounts in its tax returns for the respective years; the Commis-

sioner disallowed the deductions on the ground that these amounts represented additional costs of the property and were recoverable through the depletion allowance (R. 39). The Tax Court and the Circuit Court of Appeals sustained the Commissioner's determination, holding that the payments to Gulf were not to be excluded or deducted from the taxpayer's gross taxable income (R. 51–59, 66–76).

SUMMARY OF ARGUMENT

An interest in net profits from the operation of an oil and gas lease is not subject to the allowance for depletion unless it is associated with an economic interest in the oil and gas in place. In determining whether one who has the right to share in net profits has the requisite economic interest, no importance is to be attached to the type of instrument by which the transfer of exploitation rights was accomplished or to the presence or absence of legal title, in the transferor, to the deposits; rather, the depletable interests of the parties are to be determined exclusively by the provisions for payment. Under the decisions of this Court, such interests only exist where there is a right to share in gross production of the oil or its proceeds, and the right to receive a share of net operating profits is not depletable unless the recipient is also entitled to receive oil royalties. Accordingly, in the present case, when Gulf assigned its interests in the oil

and gas leases, and only retained the right to share in the net profits from operations, it no longer had an economic interest in the oil and gas in place, it was not entitled to the depletion allowance with respect to the net profit payments it received, and the taxpayer may not exclude from its gross taxable income, as "rents or royalties," the payments to Gulf.

Even if the provision for payment should not be considered as the exclusive criterion of the existence of a depletable interest, the decision below is correct for the reason that Gulf "sold" its entire interest to the taxpayer, and this case is, therefore, not distinguishable from *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372.

The net profit payments made by the taxpayer to Gulf constitute the purchase price of the taxpayer's capital investment in the property which is recoverable only through the allowance to the taxpayer for depletion. Accordingly, the payments may not be deducted by the taxpayer as an ordinary and necessary business expense under Section 23 (a) of the Revenue Acts of 1934 and 1936.

ARGUMENT

The taxpayer may not exclude or deduct from its taxable gross income that portion of its net profits from operating an oil and gas lease paid to its assignor's transferor

The taxpayer in this case acquired the working interest in a certain oil and gas lease from J. G.

Sutton who, in turn, had obtained his rights by assignment from the Gulf Refining Company of Louisiana, referred to as Gulf (R. 35, 45).[1] Under the assignment, the taxpayer was obligated to pay underlying and over-riding royalties to the original lessor and original lessee; Gulf was entitled to receive 50 percent of the taxpayer's net profits from operations, the assignment providing what expenses were to be deducted from gross revenues in calculating the profits (R. 36–38, 46–47).

1. The precise issue presented for decision is whether the taxpayer may exclude or deduct from its taxable income the net profit payments made to Gulf during the taxable years. Whether an amount equal to the payments is to be excluded from the taxpayer's gross taxable income obtained from operations presents the same basic issue as whether those payments are "gross income from the property" to Gulf, payments on which Gulf would be entitled to percentage depletion under Section 114 (b) (3) of the Revenue Acts of 1934 and 1936 (Appendix, *infra*, pp. 33–34) *Anderson* v. *Helvering*, 310 U. S. 404, 407. The identity of these issues derives from the fact that the aggregate of the single allowance for percentage depletion to be deducted by the holder of the working interest and by all others sharing in produc-

[1] For purposes of simplification, the taxpayer may be considered as being Gulf's assignee and will be referred to in that manner.

tion cannot exceed 27½ percent of the gross proceeds from the sale of the oil and gas. The Revenue Act of 1926, c. 27, 44 Stat. 9, was so construed in *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, and Congress, beginning in Section 114 (b) (3) of the Revenue Act of 1932, c. 209, 47 Stat. 169, has enacted that rule [2] by providing, in effect, that the holder of the working interest is not entitled to percentage depletion on any "rents or royalties" [3] paid, it being required that an amount equal to such payments (as to which others would be entitled to depletion) be excluded from a taxpayer's gross income from the property. The amounts which are thus excluded from the depletion basis are likewise excluded from the operator's gross taxable income since he is merely paying to others the proceeds from the sale

[2] H. Conference Rep. No. 1492, 72nd Cong., 1st sess., p. 11 (1939—1 Cum. Bull. (Part 2) 539, 542).

[3] The term "rents" in Section 114 (b) (3) is used synonymously with the word "royalties". The latter clearly refers to a share of gross production or the proceeds thereof (*Anderson* v. *Helvering*, 310 U. S. 404, 409) and the term "rents or royalties" has been used to describe a stipulated amount payable per ton for the privilege of extracting iron ore (*Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503, 522). If there is any shading of meaning between the two words, it is clear that the word "rents" is not used in its ordinary sense, since in order to constitute gross income from the property to the recipient, it must be "gross income from the oil and gas". *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376, 382. Thus, the word "rents" like the word "royalties" denotes payments received from the production of oil and gas.

of oil belonging to them. *Thomas* v. *Perkins*, 301 U. S. 655. "Such deductions become the gross income of the lessor." *Kirby Petroleum Co.* v. *Commissioner*, decided by this Court on January 28, 1946, No. 56, this Term, slip opinion, pp. 4–5.

As a result, if Gulf does not have an economic interest in the oil in place and is not entitled to the depletion allowance with respect to the net profit payments received, the taxpayer has not sold any oil in which Gulf has an interest, and there is nothing in the statute or Regulations permitting the taxpayer to exclude an amount equal to these payments from its taxable income derived from operations.[4] The taxpayer agrees with these fundamental principles (Br. 7–11).

This Court has already passed on the question whether a right to share in net profits derived from the production and sale of oil is a depletable interest, as presented in three different settings. In *Helvering* v. *O'Donnell*, 303 U. S. 370, it was decided that one who had no previous economic investment in the oil deposits did not obtain a depletable interest by acquiring the right to share in net operating profits under a contract providing for the sale of corporate stock. *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, determined that one who had previously possessed an economic interest in the oil in place, but had sold all his

[4] Whether the payments are to be included in the taxpayer's gross income, but are deductible as business expenses is discussed at pp. 30–31, *infra*.

right, title and interest in certain oil and gas leases, prospecting permits, and equipment, no longer had a depletable interest even though he was still entitled to a stipulated percentage of the net profits. In *Kirby Petroleum Co.* v. *Commissioner*, *supra*, it was held that a lessor who received a share of gross production by way of oil royalties and also a portion of net operating profits was entitled to calculate percentage depletion by including both payments in its "gross income from the property". The *Kirby* opinion also indicated (slip opinion, p. 5) that the lessee could exclude both payments from its gross income as "rents or royalties" paid.

When these cases are considered together, it must be evident that an interest in net profits cannot, by itself, be decisive of the existence of an economic interest in the oil and gas in place which entitles the owner to a deduction for depletion. That is, before it can be determined whether the recipient of net profit payments may claim the depletion allowance, other factors must appear showing his relationship to the oil deposits. If a taxpayer who merely shares in profits has no other economic interest in the minerals, the *O'Donnell* and *Elbe* cases would require that he be denied the depletion deduction. Thus, the fact that Gulf was entitled to receive a portion of the taxpayer's net profits from operations does not, of itself, evidence Gulf's depletable interest or

establish the taxpayer's right to exclude anything from its gross taxable income.

We do not understand that the *Kirby* case has detracted from the force of the *O'Donnell* and *Elbe* decisions. On the contrary, the *Kirby* opinion, referring to those cases with approval, stated that *Anderson* v. *Helvering*, 310 U. S. 404, had correctly summarized the decisions as holding (slip opinion, p. 6): "that a share in 'net profits' dissociated from an economic interest, does not entitle the holder to a depletion allowance." In this respect, the *Kirby* decision must be regarded as establishing that an interest in net profits differs from the right to share in gross production which, regardless of all other circumstances, is always a depletable interest and constitutes "gross income from the property" to the recipient. *Thomas* v. *Perkins*, 301 U. S. 655;[5] *Palmer* v. *Bender*, 287 U. S. 551; *Bankers Coal Co.* v. *Burnet*, 287 U. S. 308; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Burnet* v. *Harmel*, 287 U. S. 103; *West* v. *Commissioner*, 150 F. 2d 723 (C. C. A. 5th), certiorari denied January 28, 1946, Nos. 667, 668, 669, and 670, this Term.

While there are some statements in the *Kirby* opinion which, if read alone, might be taken to mean that a share of net profits is, of itself, a depletable interest, it seems clear that such a prin-

[5] (Slip opinion, p. 4):

"If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted

ciple, which would have required overruling the *Elbe* and *O'Donnell* decisions, was not announced by the Court. This is especially true in view of the reaffirmation of those cases by the *Kirby* opinion and in the light of the court's statement, in the *Kirby* opinion, that an interest in net profits is not depletable when disassociated from an economic interest.

Starting with the premise that the recipient of net profits must have some additional economic interest in the oil deposits before the payments can evidence a depletable interest, it becomes pertinent to inquire what factors absent in the *Elbe*

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by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to share a net profit. * * *"

(Slip opinion, p. 4, fn. 6):

"While the reservation of royalties shows an economic interest in the oil necessary for the satisfaction of the royalties, such reservation would not show an economic interest in oil not necessary for the payment of the royalties. But see *Estate of Japhet* [*Japhet*], 3 T. C. 86."

(Slip opinion, p. 5):

"If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessors by the lessees was the portion of "net income" paid under the leases, it would be clear that such payment of "net income" would taxwise be rent or royalty paid by the lessees for the privilege of extraction. * * *"

The Tax Court has interpreted the last quoted excerpt as meaning that an interest in net profits is, by itself, depletable. *Procter and Gamble Manufacturing Co.* v. *Commissioner*, memorandum opinion, February 18, 1946, Docket No. 3338; *Murphy* v. *Commissioner*, decided February 28, 1946, 6 T. C. No. 42.

case were present in the *Kirby* case so that the payments were depletable in the latter but not in the former. While the *Kirby* opinion is not explicit in that regard, we are able to discern only two matters which might be of sufficient significance to distinguish the cases. In the *Kirby* case, the taxpayer had an economic investment in the oil, as evidenced by its retained royalty interest. Such an interest was not present in the *Elbe* or *O'Donnell* cases, and none was retained by Gulf in the present case. Accordingly, if the presence of oil royalties was the crucial factor on which the *Kirby* case was decided, this case is governed by the *Elbe* and *O'Donnell* decisions.

The *Elbe* case might also be distinguishable from the *Kirby* case on the ground that in the former there had been a "sale" or "assignment" of leases while in the latter the underlying oil was "leased". If this was the source of distinction between the cases, we also believe that the present controversy is governed by the *Elbe* case since here Gulf "sold, conveyed and transferred" "all oil and gas rights, titles and interests" created by the leases (R. 35), and did not reserve any rights in the oil, either before or after production. Indeed, from the fact that Gulf could, if it so desired, "purchase" from the taxpayer the "oil produced" (R. 38–39), it is evident that Gulf intended to make a complete "sale" of the oil deposits. It may be noted that both the Tax Court (by relying on its decision in *Quintana Petroleum Co.* v. *Commissioner*, 44 B. T. A. 624)

and the court below believed that this case was controlled by the *Elbe* decision. (R. 53–54, 88.)

Thus, if the *Kirby* decision rests on either or a combination of these circumstances, the taxpayer in this case may not exclude the payments from its gross income and Gulf does not have a depletable interest.

2. Although the decision below is sustainable on either ground, we believe that the previous decisions of this Court, which were not disapproved in the *Kirby* case, make it evident that the retention of the royalty interest was the factor in the *Kirby* case which entitled the lessor to depletion on the net profit payments; the circumstance that a lease had been executed was not sufficient to distinguish the *Elbe* case in which there had been a sale or an assignment of the leases. A precise ruling on this would clarify the principle to be applied in pending cases and would undoubtedly diminish future litigation affecting this problem. Ascertaining the dividing line between the *Elbe* and *Kirby* opinions becomes particularly difficult where a transferor of a lease retains an interest in net profits but is not entitled to any oil royalties, and to attempt to draw the line according to whether the transfer was an assignment or a sub-lease would not only make the statute difficult to administer but would be to revert to principles repeatedly rejected.

The consistent rulings of this Court demonstrate that the existence of a lessor-lessee relationship

can scarcely be regarded as material to the decision reached in the *Kirby* case. *Burnet* v. *Harmel*, 287 U. S. 103, held that differences in local law respecting title to the oil in place were not important and that, even though a lessee acquired title before severance under Texas law, and despite the receipt of an initial cash payment, a sale of a capital asset within the meaning of the federal taxing statute did not take place upon the execution of a typical oil and gas lease in Texas. The opinion emphasized the point that where the lessor received a bonus and oil royalties, whether the lessee acquired title before or after severance (p. 111)—

> The economic consequences to the lessor of the two types of lease are the same. Under both, the payments made by the lessee are consideration for the right which he acquires to enter upon and use the land for the purpose of exploiting it, * * *.

Palmer v. *Bender*, 287 U. S. 551, reiterated the principles that (pp. 555–556) "The formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant", that (p. 557) "the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property", and held that a depletable interest is acquired when one (p. 557) "secures, by any form of legal relationship, income derived from the extraction of the

oil, to which he must look for a return of his capital." Holding that the right to share in the production of oil was a depletable interest, the Court, in *Palmer* v. *Bender*, observed that a distinction based on the form of transfer was not material and refused to consider the question whether the particular instruments constituted subleases, with reversionary rights in the sublessor, or assignments.

Again, in *Thomas* v. *Perkins*, 301 U. S. 655, notwithstanding that the conveyance was an assignment, and despite the fact that the granting clause purported to transfer the oil in place to the assignee, it was ruled that the assignor retained a depletable interest by reserving an oil payment payable out of the oil as produced; consequently, it was held that the payments to the assignor were not part of the assignee's income. Summarizing this decision, and referring to *Palmer* v. *Bender*, *supra*, and *Burnet* v. *Harmel*, *supra*, the Court stated in *Anderson* v. *Helvering*, 310 U. S. 404, 411:

> The decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type.

Also, in the *Kirby* case, with reference to what constitutes an economic interest in the oil, it was stated (slip opinion, pp. 3–4):

> By this is meant only that under his contract he [a taxpayer] must look to the oil in place as the source of the return of his capital investment. The technical title to the oil in place is not important. Title in a case of a lease may depend upon the law of the state in which the deposit lies. *Burnet* v. *Harmel*, 287 U. S. 103, 109–110. The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted. See *Anderson* v. *Helvering*, 310 U. S. 404, 407.

The reasons why an economic investment and depletable interest in the underlying oil are determined exclusively from the provisions for payments, and not from the kind of legal relationship involved, have been fully developed in the decided cases. They need only be outlined here. The owner of mineral property who extracts and sells the deposits has been held to be engaged in a business and not in the conversion of capital from one form to another. Although an ultimate sale of the severed deposits is always involved, such operations are distinguished from a sale of the property itself where the owner no longer will obtain a return from future operations. *Stratton's Independence* v. *Howbert*, 231 U. S. 399. Similarly, where the owner permits someone else to carry on the actual operations and to sell the severed minerals, each being entitled to a portion of the gross product or the gross proceeds from its sale,

no sale of a capital investment takes place. While ownership of the deposits passes at some time from the owner to the operator, the owner's receipts are not derived from the sale of a capital asset but are considered as ordinary income, his capital investment, like that of the operator, being returned by the statutory allowance for depletion. *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503; *Lynch* v. *Alworth-Stephens* Co., 267 U. S. 364. As a result of the peculiar conditions of the industry, regardless of when ownership passes under local law, no sale of a capital asset takes place if the owner retains a continuing share of gross production or the proceeds therefrom. *Burnet* v. *Harmel*, 287 U. S. 103.

A further basis for disregarding legal title to the oil, which is fully as important as the practical economic considerations, lies in the fact that such legal relationships are determined under local law. Since variations occur from State to State, a uniform impact of the taxing scheme would not be possible if the criterion applied is determined by local concepts of title. *Burnet* v. *Harmel*, *supra*. The only single standard capable of uniform application to transactions having common economic characteristics is one that classifies tax consequences by a taxpayer's rights in gross production of the oil or its proceeds. Whenever such a right exists, whether acquired or retained, there is an economic investment in the underlying oil which is subject to an allowance for depletion.

Helvering v. *Bankline Oil Co.*, 303 U. S. 362; *Helvering* v. *Twin Bell Syndicate, supra; Burnet* v. *Harmel, supra; Palmer* v. *Bender, supra; Thomas* v. *Perkins*, 301 U. S. 655. However, a depletable interest is not possessed by one who had such an investment but is no longer entitled to share in gross production, or by one who never acquired such a right, an interest in net profits not being considered as a share of production. *Helvering* v. *Elbe Oil Land Co., supra; Helvering* v. *O'Donnell, supra.*

If legal title to the oil in place is not of controlling significance, much less should other differences under local law with respect to the legal relationship existing between vendor-vendee, lessor-lessee, sublessor-sublessee, and assignor-assignee be made the standard, with the result that a taxpayer entitled to a particular kind of payment would be granted the allowance for depletion under one relationship but denied it under another. It has been suggested that the reversionary rights of a lessor distinguish a lease from a sale, so that a net profit payment is depletable when received by a lessor or a sublessor but is not when received by a vendor or assignor.[8] How-

[8] *Innis* v. *Commissioner*, decided June 29, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,246) (pending on the Government's appeal in the Circuit Court of Appeals for the Ninth Circuit); *Williams Bar Dredging Co.* v. *Commissioner*, decided June 30, 1945 (1945 P-H T. C. Memorandum Decisions Service, par. 45,244) (pending on the Government's appeal in the Circuit Court of Appeals for the

ever, in *Palmer* v. *Bender, supra,* the Court explicitly rejected the notion that the existence or absence of a reversionary interest has any material bearing on the problem. In addition, we wish to point out that the presence of a reversionary interest may be of little economic significance. The usual oil and gas lease extends for as long as oil and gas may be produced in paying quantities. See 2 Summers, *The Law of Oil and Gas,* Section 284, *et seq.* Thus, the lessee is entitled to extract all the underlying oil, or may continue to do so until production is no longer profitable. Since, upon expiration of the lessee's term, the lessor's reversionary interest may attach to oil reserves that have become exhausted or depleted beyond the point where production would be feasible, it can scarcely be considered that a lessor who does not retain an interest in gross production has any different economic interest in the oil deposits from that of a vendor or assignor.

Nor do we find anything else peculiar to the lessor-lessee relationship which would, without regard to the type of payment reserved, lead to the conclusion that a lessor always has an economic interest in the deposits. The fact that affirmative obligations, such as the duty to drill,

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Ninth Circuit); *Gracey* v. *Commissioner*, 5 T. C. 296, 301–305 (pending on cross-appeals in the Circuit Court of Appeals for the Fifth Circuit); *Felix Oil Co.* v. *Commissioner*, decided December 18, 1942 (1942 P-H B. T. A. Memorandum Decisions, par. 42,662), affirmed, 144 F. 2d 276 (C. C. A. 9th).

may be imposed on the lessee, or that the lessor may reacquire the exploitation rights if there has been a forfeiture or abandonment, are not singular characteristics of leasing agreements. Similar provisions may appear in other kinds of transfers. Indeed, variations appearing from instrument to instrument make sport of any attempt to classify the legal relationship of the parties respecting the oil in place into closed compartments labelled "sales", "leases" and "assignments". For example, in the present case, Gulf executed (R. 35) an "assignment" which recited that it "has sold, conveyed and transferred * * * all oil and gas rights, titles, interests or privileges" with respect to the lease. In all material respects, the situation cannot be differentiated from the "sale" of the leases involved in the *Elbe* case,[7] in which the "purchaser" undertook to pay all oil royalties and to fulfill all drill-obligations imposed by the original leases, and the properties could be reacquired by the "vendor" if the purchaser elected not to continue operations.[8] The same obligations were assumed in the present case, in which the taxpayer undertook the payment of the overriding and

[7] The fact that Gulf retained the right to produce sulphur (R. 38) cannot have any bearing on whether it retained an economic interest in the oil deposits. Also, the provision (R. 38–39) that entitled Gulf to purchase the oil and gas produced by paying the average posted price, while giving Gulf an economic advantage, does not evidence a depletable interest. *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362.

[8] R. 45–47, 55–58, 60, No. 446, October Term, 1937.

underlying royalties, was obligated to continue the drilling requirements under the original lease, and agreed to reassign the properties to Gulf if the taxpayer desired to discontinue operations (R. 35–36). Again, it may be observed that even when a transaction is denominated a sale, the relationship of the parties may not be distinguishable in any respect from that involved in a typical leasing agreement. *West* v. *Commissioner*, 150 F. 2d 723 (C. C. A. 5th), certiorari denied, January 28, 1946, Nos. 667, 668, 669, and 670, this Term.

We submit that, as is true of title, other variations in the legal relationship of the parties cannot be resorted to as the standard for determining the decisive question. These variations, which also have their foundation in local rules of law, would not permit the uniform operation of the taxing statute intended by Congress. *Burnet* v. *Harmel, supra.* Moreover, it is apparent that grave administrative difficulties would be encountered in attempting to weigh nuances of meaning if classification by some such standard should be required. Unless the door is to be opened so that skillful draftsmen may determine tax consequences merely by selecting the requisite name for the instrument and inserting the proper phrases, and unless the economic consequences of a transaction are to be ignored, the key to the distinction between the *Kirby* and *Elbe* cases cannot be found in the kind of instrument involved or the fact that one was called a sale and the other

a lease. To the extent that the Tax Court has, in some cases, rested its decision on such a basis we believe that it has been in error. (See footnote 6, pp. 19–20, *supra.*)

We submit that only one consistent pattern is discernible from the decisions of this Court. The rule which, we believe, runs through all the decided cases may be stated thus: Regardless of the type of transfer involved and legal concepts respecting title to the oil in place, and regardless of any other rights and duties of the parties, a capital investment in the deposits which evidences a depletable interest only obtains where there is a continuing right to share in the gross production of the oil or the proceeds. Where this exists and the recipient has an additional right to share in net profits from operations, his basis for percentage depletion, i. e., the "gross income from the property", includes both payments, and an amount equal to both payments is to be excluded from the payor's gross income as "rents or royalties" paid. *Kirby Petroleum Co.* v. *Commissioner, supra.* Where there is no right to share in gross production, an interest in net profits is not depletable; since the recipient does not have any present and continuing rights to production, the payor may not exclude the payments as "rents or royalties".[9] *Hel-*

[9] The net profit payments are clearly not "royalties" (*Anderson* v. *Helvering*, 310 U. S. 404, 409) and, when paid to one who has given up his present rights to production, they can scarcely be considered as "rents". See footnote 3, p. 8, *supra.*

vering v. *O'Donnell, supra; Helvering* v. *Elbe Oil Land Co., supra.* The Tax Court, on occasion, has considered that the presence or absence of a royalty interest determines whether an interest in net profits is depletable. *Estate of Japhet* v. *Commissioner,* 3 T. C. 86, 93; *Crawford* v. *Commissioner,* decided March 24, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,098), affirmed, 148 F. 2d 776 (C. C. A. 9th), affirmed January 28, 1946, No. 197, this Term.

As a result of the *Kirby* decision, an interest in net profits resembles a cash payment which is depletable as a bonus [19] when the recipient has continuing rights to share in production by way of an oil royalty (*Burnet* v. *Harmel, supra; Bankers Coal Co.* v. *Burnet,* 287 U. S. 308), but is not depletable by the recipient or excludible by the payor when it is not associated with a royalty interest (*Helvering* v. *O'Donnell, supra; Helvering* v. *Elbe Oil Land Co., supra; Anderson* v. *Helvering, supra*).

Such a rule is not only in accord with the previous decisions of this Court but has the obvious advantage of avoiding undue administrative complexity in the administration of a statute which

[19] We do not suggest that a net profit payment is identical with a bonus, which is considered as "payment in advance for oil and gas to be extracted". *Herring* v. *Commissioner,* 293 U. S. 322, 324. It resembles a cash payment, however, in that its character as a depletable interest can only be determined from the economic investment of the recipient with which it is associated.

was intended to provide "a rule of thumb". *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321. Even if arguments of equal weight could be advanced in support of a rule based on distinctions between subleases and assignments, we submit that simplicity of administration is the "expediency" which should "tip the scales" in favor of the principle contended for by the Commissioner. Cf. *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 330.

Under such a view, when Gulf transferred its interest without retaining any right to future gross production, it no longer had an economic interest in the oil deposits, its share of the net profits was not "gross income from the property" with respect to which it would be entitled to depletion, the taxpayer did not obtain any proceeds from the sale of oil belonging to Gulf, and there is no warrant for the taxpayer's exclusion of the payments from its gross taxable income as a "rent or royalty paid."

3. The taxpayer agrees with the Commissioner's contentions that the formalities of the instrument and the presence or absence of legal title to the oil in place are immaterial considerations (Br. 7–11). It also, apparently, admits that no distinctions are to be drawn between subleases and assignments, and concedes that the retention of a reversionary interest is not of controlling significance (Br. 23–24). With these irrelevant factors discarded, as they should be, the issue between the parties is focused on the taxpayer's

principal contention (Br. 12), that Gulf's "right to receive [net profit] payments which depend solely upon the production and sale of the oil in place to which Gulf must look for the return of its capital investment is of and in itself an economic interest * * *" and the corollary proposition that (Br. 20): "* * * there is no essential difference between a gross royalty and one payable out of net profits * * *."

The taxpayer's argument, however, is necessarily negated by the ruling of the *Kirby* decision that the right to receive net profits from operations is not a depletable interest unless it is associated with an economic interest in the oil in place. We have already demonstrated that the *Kirby, O'Donnell* and *Elbe* decisions refute the taxpayer's premise that such an interest in net profits is depletable by itself. The taxpayer has altogether failed to point to any economic interest of Gulf which is associated with its interest in net profits.

As a result, the taxpayer is forced to distinguish the *Elbe* case on grounds which are most infirm. It is first asserted that the *Elbe* case differs from the present one because the former involved a large cash payment and that a sale would have been involved there even if the transferor had retained a royalty interest payable after the transferee had been reimbursed for the costs of acquisition (Br. 20). We submit that this is a misconception of the decision. If such a royalty interest had been retained, the

Elbe case could have been quite similar to a typical bonus situation. See *Burnet* v. *Harmel*, *supra*. But it was because there were no royalties retained and because the right to receive net profits was not the retention of an "investment" in the oil, that a sale was considered as having taken place in the *Elbe* case.

If, in the present case, Gulf had also received a cash payment, this alleged difference between the cases would not exist. Yet, despite the taxpayer's reliance on the cash payment as a differentiating factor, it also (somewhat contradictorily) states (Br. 12) "* * * if Gulf had received a cash bonus for the execution of the instrument here involved, such a cash payment would have been ordinary income * * *."

Where developed properties are transferred, as in the *Elbe* case, the transferor may be able to obtain a cash payment since the transferee will not be required to pay development expenses. Where the properties, as here, are not developed and the transferee assumes a much greater risk of losing the money which must be invested before it can be determined whether oil will be found in paying quantities, the transferee may pay only a nominal cash consideration or none at

[11] *Bankers Mortgage Co.* v. *Commissioner*, 141 F. 2d 357, rehearing denied, 142 F. 2d 130 (C. C. A. 5th), certiorari denied, 323 U. S. 727, relied on by the taxpayer (Br. 20) is not contrary. The effect of that decision is to hold that a present sale can take place where the transferor does not retain a present interest in gross production but may reacquire one in the future, depending upon certain contingencies.

all. Yet, we submit, the transferor's relationship to the oil resulting from an interest in net profits is not essentially different in either situation. Unless the transferor retains an interest in gross production by way of oil royalties, the receipt of a portion of net operating profits is not its "gross income" from the sale of oil "even though continued production is essential to the realization of such profits." (*Anderson* v. *Helvering*, *supra*, page 409.)

The taxpayer also attempts to differentiate the *Elbe* case on the ground that the parties there intended a sale of the properties (Br. 17). We do not believe that such an intention is any more controlling than is the form of the instrument chosen. In addition, as we have already shown, the instrument here possesses as many indications that a sale was intended as was true in the *Elbe* case. See *supra*, pp. 13, 21–22.)

We fail to see what significance can be attached to the fact that the properties conveyed in the *Elbe* case were already producing oil in paying quantities while here development had not yet taken place (Pet. Br. 17). Nor do we believe that the character of the net profit payments in the *Elbe* case was any different from those involved here even though, in the former case, the cash payments were to be deducted before net profits could arise.[12] While no cash payments were made

[12] It may be noted that in *Commissioner* v. *Crawford*, *supra*, net profits were to be payable only after the lessees had been reimbursed for the cash payments made.

to Gulf, the net profits payments here, too, would be made only after development costs had been recouped by the taxpayer. Such expenses, which would normally exceed income during the period of development, might result in no net profits being payable to Gulf for some time after oil was discovered in paying quantities.[13]

Even if the *Elbe* case could be satisfactorily distinguished on any of these grounds, it is apparent that there can be no escape from the *O'Donnell* decision where no cash payment was involved. If Gulf's relationship to the property is to be determined only from its right to receive a portion of the operating profits, it is difficult to see how Gulf, by retaining an interest in net profits, reserved any more of a depletable interest than was obtained by the taxpayer in the *O'Donnell* case, who also acquired only the right to share in such profits. Indeed, the *O'Donnell* case refutes the taxpayer's basic assumption that the right to receive such payments is no different than the right to receive oil royalties, it being well settled that even a stranger to the property who acquires the right to share in gross production acquires a depletable interest in oil in place. *Fleming* v. *Commissioner*, 121 F. 2d 7 (C. C. A. 5th); *Lee* v. *Commissioner*, 126 F. 2d 825 (C. C. A. 5th);

[13] It may be noted that, although the taxpayer proceeded to develop the properties shortly after the acquisition of the working interest in 1933 (R. 39), only $17,406.19 of net profits was payable to Gulf in 1936, while $232,498.94 was payable in 1937.

Laster v. *Commissioner*, 128 F. 2d 4 (C. C. A. 5th).

4. Finally, we wish to point out that if the payments to Gulf are not to be excluded from the taxpayer's gross income, the taxpayer may not achieve the same tax result by deducting the payments as ordinary and necessary business expenses under Section 23 (a) of the Revenue Acts of 1934 and 1936 (Appendix, *infra*, p. 32). The payments made are clearly consideration for the taxpayer's acquisition of its economic interest in the minerals and, as such, are part of the "purchase price". *Helvering* v. *Elbe Oil Land Co.*, *supra*, page 375. Since the payments constitute the cost of the property, they enter into the basis under Section 113 (a) of the applicable Revenue Acts (Appendix, *infra*, p. 33) which, by Section 114 (b) (1), is specifically made the basis for depletion allowable under Section 23 (m).[14] The taxpayer's capital investment being returnable by the depletion allowance, it may not obtain a multiple return by deducting a capital item as an expense. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Schermerhorn Oil Corp.* v. *Commissioner*, 46 B. T. A. 151; *North American Oil Consolidated* v. *Commissioner*, 12 B. T. A. 68, reversed on other grounds,

[14] It is not material that the taxpayer may be entitled to percentage depletion in excess of cost depletion. The former is an arbitrary allowance replacing discovery depletion which may result in deductions greatly in excess of all depletable capital costs, but the depletion allowance may not be less than that based on cost. It will be noted that, in this case, cost depletion is allowable for 1938. (R. 52.)

50 F. 2d 752 (C. C. A. 9th), affirmed, 286 U. S. 417; *Quintana Petroleum Co.* v. *Commissioner, supra.* But see *Innis* v. *Commisioner, supra.*

In this connection, it may be observed that the taxpayer's hardship argument (Br. 25–26) is without foundation.[15] If the taxpayer had paid a stipulated cash consideration in installments for acquiring its working interest in the property, it would not have been entitled to a return of its capital except by the allowance for depletion. It is not to be placed in a preferred position because the consideration is measured by its operating profits.

CONCLUSION

The judgment of the Circuit Court of Appeals is correct and should be affirmed.

Respectfully submitted.

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MARCH 1946.

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[15] The depletion deductions allowable to the taxpayer (if the decision below is affirmed) may be compared with the net profit payments made to Gulf which, the Commissioner contends, constitute part of the taxpayer's capital cost of acquiring the property (R. 12, 15, 39, 41):

Year	Depletion Allowable	Payments to Gulf
1936	$150,533.20	$17,406.19
1937	249,599.64	232,498.94
1938	286,128.23	286,128.28

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the ap-

proval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).)

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*— The basis of property shall be the cost of such property; * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than

it would be if computed without reference to this paragraph.

The corresponding provisions of the Revenue Act of 1934, c. 277, 48 Stat. 680, are substantially the same.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *
>
> * * * * * *
>
> ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 23 (b)–1 to 23 (q)–1. Double deductions are not permitted. Amounts deducted under one provision of the Act cannot again be deducted under any other provision of the Act. * * *
>
> ART. 23 (m)–1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*— * * *
>
> * * * * * *

(g) The term "gross income from the property," as used in sections 114 (b) (3) and 114 (b) (4) (A) and articles 23 (m)–1 to 23 (m)–28 of Regulation 94 * * * means the following:

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. If the oil and gas are not sold on the property but are manufactured or converted into a refined product prior to sale, or are transported from the property prior to sale, the gross income from the property shall be assumed to be equivalent to the representative market or field price (as of the date of sale) of the oil and gas before conversion or transportation.

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in the form of bonus payments or advanced royalties (see article 23 (m)–10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

* * * * * *

ART. 23 (m)–4. *Computation of depletion based on a percentage of income in the case of oil and gas wells.*—Under section 114

(b) (3), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ percent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property. (For definitions of "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property," see article 23 (m)-1 (*g*) and (*h*).) In no case shall the deduction computed under this article be less than it would be if computed upon the cost or other basis of the property provided in section 113.

* * * * *

The corresponding provisions of Treasury Regulations 86, promulgated under the Revenue Act of 1934, are substantially the same.

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SUPREME COURT OF THE UNITED STATES.

No. 361. OCTOBER TERM, 1945.

Burton-Sutton Oil Company, Incorporated, Petitioner,
vs.
Commissioner of Internal Revenue.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[April 22, 1946.]

Mr. Justice REED delivered the opinion of the Court.

The taxpayer, the petitioner here, is the operating company for the production of oil from Louisiana lands. The taxpayer acquired a contract from J. G. Sutton, grantee in the contract, that imposed upon the grantee the obligation to develop the oil-land. For that purpose the contract transferred to the grantee all oil rights previously obtained by S. W. Sweeney by a lease from the owners of the land, the Cameron Parish School Board. Through another transaction the grantor in the Sutton contract, the Gulf Refining Company of Louisiana, acquired these rights from Sweeney. An underlying oil royalty was retained by the School Board and an overriding oil royalty by Sweeney. The contract between Gulf and Sutton required the grantee-operator, who is now this taxpayer, to pay to the grantor, Gulf, 50% of the proceeds of the oil produced and sold from the land, deducting from the proceeds certain itemized expenses of the producer. Those expenses are so general in character that it may be said fairly that Gulf was to receive 50% of the net from operations.

The issue here is the correctness of the taxpayer's manner of handling this 50% net from operations, paid to Gulf, in its return for federal income tax for its fiscal years ending during 1936, 1937 and 1938 under the Revenue Acts of 1934 and 1936. The taxpayer deducted these payments of 50% of net income from its income for each of the years from the oil sold from the property. It claimed that Gulf retained an economic interest in the oil in place to the extent of this 50% payment. The Tax Court upheld the Commissioner's inclusion of an amount equal to these 50% payments in the taxpayer's gross income. They were included by the Commissioner in the income on the theory that the 50% payments represented capital investment by the taxpayer. That is, they were a part of the cost of the lease. 3 T. C. 1187. If this theory is correct, it is proper to add an

equivalent sum, as the Commissioner did, to the taxpayer's gross income.[1] The Circuit Court of Appeals affirmed the Tax Court. *Burton-Sutton Oil Co.* v. *Commissioner*, 150 F. 2d 621.

A decision on the category of expenditures to which these [illegible] disbursements belong affects both the operators who make them and the owners, lessors, vendors, grantors, however they may be classed, who receive them. If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other.[2] The decision below conflicts in principle with *Commissioner* v. *Felix Oil Co.*, 144 F. 2d 276. *Kirby Petroleum Co.* v. *Commissioner*, No. 56 this Term, decided January 28, 1946, involved payments of a share of net income by a producer but differs from this case because the lessor there was a landowner who reserved a royalty as well as a share in the net profits. Consequently we granted certiorari. — U. S. —.

The applicable provisions in the Revenue Acts for 1937 and 1936 and the Regulations thereunder are substantially the same for the two Acts. We insert below those that seem pertinent.

[1] The Commissioner and the Tax Court allowed the taxpayer depletion upon its entire income, so adjusted, under Section 114(b).

[2] Kirby Petroleum Co. v. Commissioner, No. 56 this Term, decided January 28, 1946, slip opinion pages 4 and 5; Anderson v. Helvering, 310 U. S. 404, 407.

[3] Revenue Act of 1936, Ch. 690, 49 Stat. 1648, 1660, 1686:

"SEC. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

[illegible]

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, . . . a reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. . . .

"SEC. 114. Basis for Depreciation and Depletion.

(b) *Basis for Depletion.*—

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. . . .

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

"ART. 23 (m)-1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—

(g) The term 'gross income from the property,' as used in sections 114(b)(3) and 114(b)(4)(A) and Articles 23(m)-1 to 23(m)-28 of Regulation 94 . . . means the following:

The issue of the character of these 50% payments is not settled, however, by the statutes or regulations. These prescribe the federal income tax accounting procedure after a determination that an expenditure of an operator is or is not a rent, a royalty or an ordinary business expense, but throw little light on what is a rent or royalty.

In the *Kirby* case, we held that a payment of a share of the net profits from oil production by the operator to the owner of the land was a rent or royalty and taxable to the landowner as income from the oil property. Therefore the owner could take from the payment the 27½ per centum allowance for depletion provided by Section 114(b)(3)[1]. The reason given in the *Kirby* case for holding that the payment of a part of the net return from the property to the landowner was a royalty or rent[2] was that the owner had a capital investment—an economic interest—in the oil with a possibility of profit from that interest or investment solely from the extraction of the oil. As hereinbefore indicated, the landowner in the *Kirby* case had retained also a one-sixth oil royalty and had received a bonus. It was conceded that as both the bonus and the royalty represented a return for the sale in part of the lessor's investment in the oil in place, the lessor was entitled to depletion on both.[3]

The respondent urges that in the *Kirby* case it was the lessor's economic interest in some of the oil itself, or its proceeds, because of the bonus and royalty rights, which made the net profit payments subject to depletion in the lessor's hands; that net profits received are not depletable unless the recipient is entitled also to

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[1] In the case of oil and gas wells 'gross income from the property' as used in section 114(b)(3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well.

"In all cases there shall be excluded in determining the 'gross income from the property' an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and which are not otherwise excluded from the 'gross income from the property.'"

[2] A reading of Section 114(b)(3) shows that the "gross income from the property" means income from the oil and gas wells on the property. Helvering v. Twin Roll Syndicate, 293 U. S. 312; Helvering v. Producers Corp., 303 U. S. 376, 382. Other income would not be depletable under that section. "Rents or royalties" in the section are those payable for the privilege of extraction.

[3] Kirby Petroleum Co. v. Commissioner *supra*, p. 2; Burnet v. Harmel, 287 U. S. 103, 111; Murphy Oil Co. v. Burnet, 287 U. S. 299, 302.

oil royalties.[6] Consequently, the Government contends that in this case where there is only a share in profits due to the assignor, Gulf, the *Kirby* case conclusion on the right to depletion should not be extended but that the judgment below should be affirmed on the ground that the profit payment was a part of the purchase price. In dealing with the operator's exclusion from gross income of agreed payments to lessors or assignors of leases out of net profits and with the lessor's or assignor's rights to depletion, the Tax Court has not followed consistently the principle that a reserved royalty is necessary to make a net profit payment depletable to the lessor and deductible from gross income from the property by the operator.[7] A number of the Tax Court cases

[6] The principle upon which the Tax Court and the Circuit Court of Appeals decided this case for respondent differs from respondent's present contention. This principle was that an obligation to pay a part of net proceeds is a personal covenant of the obligor and was the purchase price for the assignment. Burton-Sutton Oil Co. v. Commissioner, 150 F. 2d 621, 622; 3 Tax Court 1187, 1194, relying upon Quintana Petroleum Co. v. Commissioner, 143 F. 2d 588, 590-91; 44 B. T. A. 624, 627; Helvering v. Elbe Oil Land Co., 303 U. S. 372.

[7] In W. S. Green, 26 B. T. A. 1017, the lessor was allowed depletion on a net income payment in addition to his royalty on the ground that the net income payment was like a bonus.

In Marrs McLean, 41 B. T. A. 565, 573, which was decided after the Elbe case, the Tax Court said a transfer of leases for cash and a share of the profits was a sale. Where only a three-fourths interest in the lease was transferred and the transferor was to have one-fourth of the net profits, depletion was allowed the assignor.

In Felix Oil Co., docket No. 107148, decided December 18, 1942, a lessor corporation that had leased its oil lands for a cash payment plus 50% of the net profits as defined in the lease and no royalty, was held to have "retained an interest in the oil in place" through its ownership of the land. "Clearly, petitioner retained an interest in the oil produced because it could compel the lessee to sell 50 percent of the production to it where if it became dissatisfied with amounts realized by the lessee." Memorandum op., p. 7. See Commissioner v. Felix Oil Co., 144 F. 2d 277, affirming. Compare A. B. Innis, T. C. Docket Nos. 2735-2736, June 29, 1945.

In Kirby Petroleum Co., 2 T. C. 1258, 1261, the Tax Court relied on the latter ruling in Marrs McLean and held that the lessor could deplete its net profits payment, as well as its royalty. It later explained this ruling as based on the Kirby Company's retention of a "one-sixth oil royalty, thus reserving to itself an interest in the oil in place." Estate of Dan A. Japhet, 3 T. C. 86, 93.

In the Japhet case, depletion on net profits from an assignee's operation was denied an assignor of a lease who had received a cash payment but had not reserved a royalty. It was said no "economic interest" was reserved.

In A. B. Innis, T. C. Docket Nos. 2735-2736, June 29, 1945, a similar problem arose as to deductibility by gold lease operators from their gross income of a share in net profits paid to the sub-lessor of the lease. The Tax Court found no difference between such a payment to a sub-lessor and one to a lessor. Both were said to have economic interests and therefore depletable rights. Felix Oil Co., supra, was followed and Quintana, supra

on depletion and deduction cited in the preceding note did involve reserved royalties as well as payments of net profits. The *Felix Oil Company* and *A. B. Innis* did not. We do not agree with the Government that ownership of a royalty or other economic interest in addition to the right to net profits is essential to make the possesor of a right to a share of the net profit the owner of an economic interest in the oil in place. The decision in *Kirby* did not rest on that point.

To let the character of the net profit payments turn wholly on the ownership of a royalty of some sort by the one who received the net profit would make the right to depletion a form of words. No such mechanical application of a national tax act is desirable. Compare *Burnet* v. *Harmel*, 287 U. S. 103, 110-11. This taxpayer's acquisition of Sutton's contract with Gulf places the taxpayer in Sutton's situation as operator of the School Board lease. The School Board and Sweeney, the original parties to the lease, unquestionably have royalties which would compel a determination that net income payments would be subject to depletion if paid to them in addition to their royalties. It does not logically follow, it seems to us, that the mere receipt of the net income payments by different lessors or assignors can change the character of the taxpayer's arrangements from leases to purchases.

It seems generally accepted that it is the owner of a capital investment or economic interest in the oil in place who is entitled to the depletion. *Anderson* v. *Helvering*, 310 U. S. 404, 407; *Eulcon Jock Gracey*, 5 T. C. 296, 302; *Kirby Petroleum Co.* v. *Commissioner*, *supra*. Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place. *Palmer* v. *Bender*, 287 U. S. 551, 557, 558. Nor has the title to

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distinguished as a sale by assignment, rather than sublease. Williams Bar Dredging Co. is in accord. T. C. Docket Nos. 3284, 4074, June 30, 1945.

In Quintana Petroleum Co., 44 B. T. A. 624, an operator-assignee acquired an oil lease by an agreement that called for payment by the assignee to the assignor of one-fourth of the net proceeds from the leased property with no reservation of royalty. The Board concluded that the assignment was a purchase and no deduction of the amount of net profits paid was allowable. See also Quintana Petroleum Co. v. Commissioner, 143 F. 2d 588.

In Eulcon Jock Gracey, 5 T. C. 296, 302, decided June 21, 1945, the Tax Court under similar circumstances followed Quintana and held an operator assignee was entitled to depletion on gross production but could not exclude the net profit payment to his assignee from his gross, as the transfer of the lease, in consideration of a net profit payment only, was a sale.

the oil in place been considered by this Court as decisive of the capital investment of the taxpayer in the oil.[8] Technical title to the property depleted would ordinarily be required for the application of depletion or depreciation. It is not material whether the payment to the assignor is in oil or in cash which is the proceeds of the oil, *Helvering* v. *Twin Bell Syndicate*, 293 U. S. 312, 321, nor that some of the payments were in the form of a bonus for the contract. *Burnet* v. *Harmel*, 287 U. S. 103, 111; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 302. Congress, however, has recognized the peculiar character of the business of extracting natural resources.[9] Leases are a method of exploitation of the land for oil and payments under leases are "income to the lessor, like payments of rent."[10] Receipts from oil sales are gross income to the operator and subject to statutory deductions. Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control of the exploitation of the land valuable benefits arising from assets dependent upon the extraction of the oil,[11] Congress provided as early as the Revenue Act of 1918[12] for equitable apportionment of the depletion allowance between them to correct what was said to be an existing inequality in the law or its administration.

[8] 287 U. S. at 557: "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

287 U. S. at 558: "Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute." Lynch v. Alworth-Stephens Co., 267 U. S. 364; Burnet v. Harmel, 287 U. S. 103, 109-10; Bankers Coal Co. v. Burnet, 287 U. S. 308; Kirby Petroleum Co. v. Commissioner, *supra*, p. [illegible].

[9] Stratton's Independence v. Howbert, 231 U. S. 399, 413-14.

[10] Burnet v. Harmel, 287 U. S. 103, 107 s.

[11] See Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370; Palmer v. Bender, 287 U. S. 551, 556.

[12] 40 Stat. 1057, 1067, 1078, §§ 214(a)(10), 234(a)(9).

[13] H. Rep. No. 767, 65th Cong., 2d Sess., September 3, 1918, Deductions (5) and for corporations, Deductions (4).

The inequality referred to under the Revenue Act of 1916, 39 Stat. [illegible] Sec. 5, Eighth (a), arose from the preferred treatment given the lessee over the lessee. See Hearings, House Committee on Ways and Means, 65th Cong., 2d Sess., pp. 455, 516-17, 523-28, 530-31. Regulations 33, Income Tax promulgated January 2, 1918, Art. 170; Regulations 45, 1920 ed., Income Tax promulgated January 28, 1921, Art. 201.

The applicable law for allowance of depletion in oil and gas wells appears in Sec. 114(b)(3). It is identical with I. R. C. Sec. 114(b)(3). This sec-

In the present case, the assignor of the petitioner before assignment had an economic interest in the oil in place, through its control over extraction. Under the contract with petitioner, its assignor retained a part of this interest—fifty per cent of net. Like the other holders of such economic interest through royalties, the petitioner looked to the special depletion allowances of Section 114 b (3) to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion under Section 114 b (3) is unimportant. Depletion depends only upon production. It is the lessor's, lessee's or transferee's "possibility of profit" from the use of his rights over production, "dependent solely upon the extraction and sale of the oil," which marks an economic interest in the oil. *See Kirby Petroleum Co. v. Commissioner, supra*, page 4. Through retention of certain rights to payments from oil or its proceeds in himself, each of these assignors of partial exploitation rights in oil lands has maintained a capital investment or economic interest in the oil or its proceeds.[14] As the oil is extracted and sold, that economic interest in the oil in place is reduced and the holder or owner of the interest is entitled to his equitable proportion of the depletion as rent or royalty. The operator, of course, may deduct such payments from the gross receipts.

Of course, such a transferor, whether the landowner or any intermediate assignor, may completely divest himself of any interest, economic or otherwise, in the extraction of the oil. As the record shows no reservation of an economic interest by Sutton, the assignee of Gulf and the assignor of petitioner, he appears to have done so in this case. *See Helvering v. Elbe Oil Land Co.*, 303 U. S. 372. While, as pointed out above, the payment of proceeds in cash, the form of the instrument of transfer and its effect on the title to the oil under local law are not decisive of the right

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tion is the result of administrative experience with oil and gas depletion. Hearings, Sen. Com. on Finance, 69th Cong., 1st Sess., p. 177-78; Hearings, House Com. on Ways and Means, 69th Cong., p. 1006. See H. Rep. No. 1, 69th Cong., 1st Sess., December 7, 1925, Discovery Value; § 204 (c) (2), 44 Stat. 16. For discussion see Helvering v. Twin Bell Syndicate, 293 U. S. 312, and Kirby Petroleum Co. v. Commissioner, *supra*, p. 3. Depletion is now an arbitrary percentage allowance based on production from the wells without regard to cost or value of the property.

[14] A participation in net profits disassociated from an economic interest does not enable a recipient of such profits to benefit from depletion. Helvering v. O'Donnell, 303 U. S. 370.

to participation in depletion under Sections 23(m) and 114(b)(3), there must be a determination under federal tax law as to "whether the transferor has made an absolute sale or has retained" such economic interest as we have just described in the preceding paragraph. *Kirby Petroleum Co.* v. *Commissioner*, *supra*, page [illegible]. We have said that the instrument should be construed as a sale when a large cash payment was made with a reserved payment that could be satisfied by future sales of the transferred property without extraction of the oil. Obviously there could be no depletion without extraction. *Anderson* v. *Helvering*, 310 U. S. 404, 412. On the other hand, we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only if, as and when produced," as the reservation of an economic interest in the oil—not a sale. *Thomas* v. *Perkins*, 301 U. S. [illegible].

The Government contends that *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, controls this case. The transfer of the leases in *Elbe* was held an absolute sale. There the transfer was for cash, deferred payments in cash, if the assignee did not take advantage of a stipulation for abandonment, and a one-third interest in the net profits of the assignee. It was further provided that Elbe, the assignor, after the transfer, should have "no interest in or to said properties," except in the case of an abandonment of the property by the assignee. This provision for the transfer of all interest of the assignor was emphasized as a significant part of the agreement for transfer. The issue upon which this Court passed was the classification of the deferred payments. Were they gross income from the property or receipts from a sale of the leases? These deferred payments were not payable out of oil sales but were payable absolutely, unless there was an abandonment. This Court concluded that the addition of a provision for the payment of a share of net profits did not qualify "in any way the effect of the transactions as an absolute sale." Page 377. In view of what we have said in this and in the *Kirby Petroleum* case as to the economic interest in the oil of a recipient of a share of net profits, the holding of *Elbe* should not be extended to the facts of this agreement.

The assignor, Gulf, in the assignment here involved, required the grantee to drill promptly, to account for production, to pay over fifty per cent of receipts, less agreed costs and expenses, and to sell the production on defined terms to grantor, if grantee [illegible]

sised to purchase." This last clause did not appear in the Elbe contract. Such a transfer of rights to exploit could not, we think, properly be construed as a sale. It is rather an assignment to the operator, petitioner here, of the right to exploit the property with a reservation in the assignor of an economic interest in the oil.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

Mr. Justice BLACK and Mr. Justice DOUGLAS dissent.

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15 See the discussion of Felix Oil Co. in note 7, *supra*.

SUPREME COURT OF THE UNITED STATES.

No. 331.—October Term, 1945.

Burton-Sutton Oil Company, Incorporated, Petitioner, vs. Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[April 22, 1946.]

Mr. Justice Frankfurter, [redacted].

The tortuous process by which the result in this case has evidently to be reached by the Court justifies calling attention again to the present unsatisfactory state of tax litigation. It is of course idle to expect that the complexities of our economic life permit revenue measures to be drawn with such simplicity and particularity as to avoid much litigation. But it is not a counsel of perfection to assume that a system of judicial oversight of fiscal administration can be devised sufficiently rational to avoid the mollifying series of cases relating to income from oil operations culminating in the present (at least in this case). The Court made a brave effort in *Dobson v. Commissioner*, 320 U. S. 489, to meet some of the difficulties of the present distribution of judicial authority in tax cases by lodging practical finality in a Tax Court decision unless it invokes a "clear-cut mistake of law." *Id.* at 502. An attempt to give adequate scope to such a doctrine of judicial abstention by dealing with the practicalities of tax matters instead of relying on the grab-bag concepts of "law" and "fact" as a basis of review has not, however, commended itself to the Court. See *Trust of Bingham v. Commissioner*, 325 U. S. 365.

To be sure even the adoption of this view would not make the Tax Court the Exchequer Court of the country inasmuch as tax litigation can go through the district courts as well as through the Tax Court. It would, however, largely centralize review in the Tax Court of Treasury determinations, assuming that the bulk of tax litigation will continue to find its way to the Tax Court.

It is suggested that the Tax Court makes differentiations from

case to case which to the uninitiated look suspiciously like conflicting opinions. But it is impossible to escape nice distinctions in the application of complicated tax legislation. And so far as over-nice distinctions are to be made, I do not see that it helps the administration of law for this Court rather than the Tax Courts to make them.

Nothing better illustrates the gossamer lines that have been drawn by this Court in tax cases than the distinction made in the Court's opinion between *Helvering* v. *Elbe Oil Land Co.*, 303 U. S. 372, and this case. To draw such distinctions, which hardly can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for respect for law. Perhaps it is inherent in the scheme which Congress has provided for review of tax litigation that we have such an unsatisfactory series of decisions as those which are sought to be reconciled by the present opinion. If so, then the call for legislation voiced in responsible quarters to reform the situation may well be heeded. See *e. g.*, Griswold, *The Need for a Court of Tax Appeals*, 1944 57 Harv. L. Rev. 1153.